Q4 2018 Commentary

NORTHWEST PASSAGE CAPITAL ADVISORS

Golconda

Once in Golconda by acclaimed financial reporter John Brooks chronicles the market events leading up to the 1929 crash and its aftermath. Golconda was a term used in the late 1880s to describe great wealth. The use of the word is a reference to Golkonda, a medieval fort in Southern India, home to some of the world's most productive diamond mines. In fact, it's where the Hope Diamond was discovered. Indian folklore refers to the city as a mythical place where everyone who passes through acquires wealth. Modern society may not fully appreciate the value of what lies beneath these mines as today it is far more fashionable to value the ideas that are produced by Silicon Valley or the trades that are generated on Wall Street. The value of diamonds and gold in building wealth are time tested while concepts like bitcoin seem to be fleeting.

Jefferson V. DeAngelis, CFA
Chief Investment Officer
jvd@nwpcapital.com
414.755.5851

172 N. Broadway, Suite 300
Milwaukee, WI 53202

History may very well treat the decade since the Great Financial Crisis as analogous to the period detailed by Brooks. There are many similarities. The roaring twenties resemble the period directly following 2010. The economic cycles, then and now, ended with financial excesses and social upheaval. In both cases, governments and central banks were able to minimize downside risk through unconventional fiscal and extremely accommodative monetary policies. The markets were quick to recover, underwritten by easy, cheap and abundant credit. Economic growth and animal spirits were slower to revive since the transmission mechanism by design is far more complex. However, as economic growth, employment and profits improved investors grew more confident and willingly took on additional risk. The Fed viewed risk taking as a signal to start withdrawing their life support for financial markets. They began to normalize interest rates through a gradual tightening of credit in 2015. In 2017, they cautiously began to reduce their balance sheet. A similar move by the Fed in the late 1930s to remove liquidity proved premature and led to a violent market reaction and a retracement of economic activity.

Policy errors are easy to identify with hindsight. 2018 seemed like the perfect environment to withdraw liquidity. There was widespread hope for a synchronized global recovery, interest rates were moving up gradually, and inflation expectations were rising. Energy and commodity prices were higher on what was widely believed to be a pick-up in demand. The Trump Tax Cuts provided the perfect political cover. The U.S. was the locomotive designated to pull the rest of the world's economies out of stagnation.

The financial markets largely discounted the optimism by February. Speculative bets on low volatility set off a rout in global equities from which European and Asian markets never recovered. By spring it became evident that a serious divergence in economic growth between the U.S. and the rest of the world was underway. There was a major reassessment of valuation across all non-U.S. markets, with Asian and European equity markets underperformed dramatically. Emerging markets (EM) were hit by a combination of falling equity prices and currency weakness. The strength in the U.S. dollar suddenly became a headwind.

Rising rates in the U.S., the threat of a global trade war, and a reduction in the Fed's balance sheet proved to be significant risks to the theme of a global revival. Fiscal stimulus had pushed the U.S. economy above its potential. Labor markets in the U.S. tightened causing fears that wage inflation could short circuit the recovery. Investors began to think that the Fed was behind the curve in reducing accommodation. The Fed responded by adopting tougher language, announcing a series of poorly timed interest rate hikes.

By the end of the year, it became apparent that the game was changing. Fears of overheating, shortages, and inflation were replaced by concerns for valuation, abundance, and liquidity. Global economies were in fact out of synch. Throughout Europe, Asia, and Latin America economies were slowing. The trade war rhetoric, the strong dollar, and U.S. interest rates proved to be contractionary to a world immersed in dollar debt. Emerging markets felt the aftershock of Chinese and European woes. The rising dollar became a threat to debtors and creditors alike. Credit spreads began to widen in both high yield and investment grade credits. The energy patch was once again the victim of slack demand in a global supply glut. Credit spreads and energy prices have become highly correlated since OPEC lost control of the pricing mechanism. Deterioration in credit spreads and energy prices has also been an early warning signal of stock market weakness. Equity investors, while usually the most optimistic, are also the least likely to sense shifts in macro headwinds.

The widening in corporate bond spreads is a direct result of the buildup in leverage by corporations in the aftermath of the Great Financial Crisis. Prior to 2010, only 12% of the corporate debt universe was rated BBB, today it is over 50%. Low interest rates and easy access to credit proved too enticing as many companies used leverage to buy back their common stock. The tax cuts of 2018 furthered the strategy of stock buybacks, M&A activity, and dividend payments. The anticipated capital spending and investment boom envisioned by the architects of the tax plan did not materialize. Corporate debt represents a significant systemic risk should the U.S. prematurely fall into recession in 2019.

To mitigate the corporate credit risk, investors should consider adding high quality EM sovereign debt to their portfolios. There is significant value in high quality EM debt relative to traditional corporate bonds of similar rating. First, the yields offered on EM debt are more attractive. The option-adjusted spread between IG U.S. corporate and IG EM USD bonds has been consistent and fairly stable risk premium which has fluctuated around 70 basis points over the past decade.[1] Second, EM sovereign debt is arguably less risky than traditional corporate bonds. The default and recovery experience of investors in EM investment grade bonds versus corporate bonds has been slightly better over the last 20 years.[2] Finally, EM sovereign debt is less correlated to the U.S. economic cycle than corporate bonds. Given the increased leverage this could prove to be a great source of diversification.

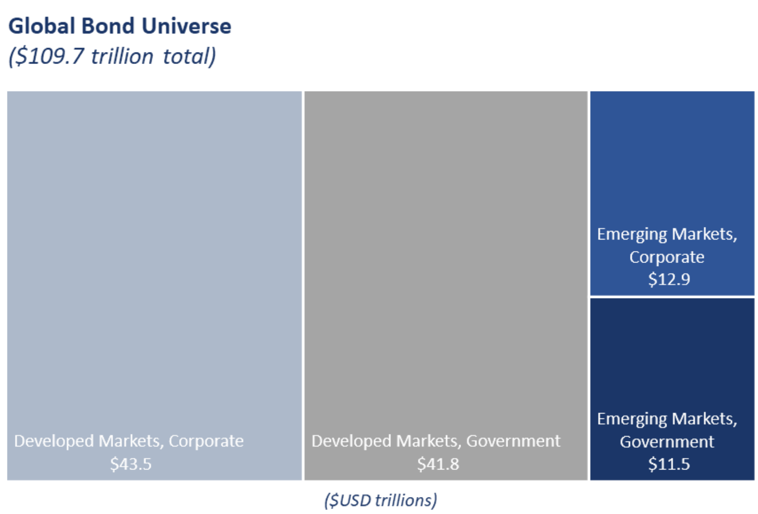

Figure 1. Global Bond Universe
Source: Ashmore as of December 31, 2017.

Domestic institutional investors are generally underweight the EM debt universe which has become a substantial component of debt markets. The global bond universe is comprised of $110 trillion of

[1] William C. Slaughter, "Long Duration Emerging Market Bonds as a Liability-Hedge Asset: An Idea Whose Time Has Come for Liability-Driven Investors." White Paper (November 2018). Northwest Passage Capital Advisors LLC.
[2] "Sovereign Default and Recovery Rates,1983-2017." Data Report. July 19, 2018. Moody's Investors Service; Cornaggia, J., Cornaggia, K., and Hund, K (2017), "Credit Ratings Across Asset Classes: A Long-Term Perspective." Review of Finance (March) Oxford University Press.

debt. In rough terms, we are twice as indebted globally relative to GDP as we were in 2007 before the Great Financial Crisis (see Figure 1). With developed markets making up about 78% of the debt and the emerging markets 22%.

The EM debt markets are roughly $25 trillion in size (see Figure 2). Most of the debt, some 88% (split nearly 50-50 government and corporate) is denominated in local currency. The growth of local markets within EM has tended to reduce the volatility inherent in markets subject to random periods of capital flight. As countries develop internal capabilities to finance development they are less reliant on foreign capital. Both Argentina and Turkey were forced to defend their currencies against rapid capital flight last year. Argentina's public sector borrowed heavily in dollars and did not have sufficient reserves to meet the outflow. In Turkey, the government was forced to raise rates to defend its currency against a potential run on its banking system which is heavily dollarized. Both events were isolated within the EM debt markets. The fear of contagion was once again overblown.

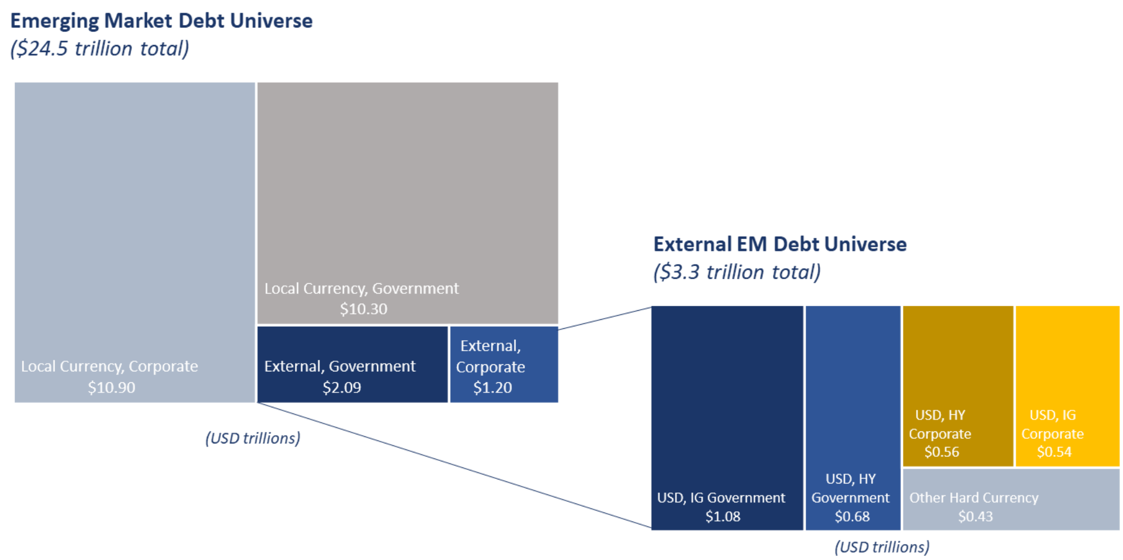

Figure 2. Emerging Market Debt Universe
Source: J.P. Morgan as of November 20, 2018.

The fact that most EM issuers were not impacted by the events in Argentina and Turkey is evidence of a maturing market -- isolated risks no longer tend to become systemic. There is a mistaken investor bias, particularly among U.S. investors, that all emerging market investments are risky, highly illiquid securities issued by highly corrupt governments and corporations in third world countries. Instead, as a result of the steady improvement in credit quality, EM debt has been one of the best performing sectors in fixed-income markets for several decades.

There is no doubt that EM debt faced headwinds in 2018 as the economic cycle matured, rates rose, and liquidity was withdrawn. There is evidence suggesting that the rapid improvement in the credit quality of EM issuers has stalled. We maintain, however, that relative to the developed world, EM countries on average continue to offer investors better opportunities. Most EM countries are experiencing stronger growth, favorable demographics, and are less indebted. Arguably, they are also less dependent on the developed world than at any point in recent history.

We contend that the outlook for emerging market debt for 2019 is more favorable. We believe the economic cycle is ending, and that global growth is slowing. Central banks will become a tailwind. Deflation, not inflation, is the dominant risk. The U.S. will pause its interest rate hikes, the European Central Bank will continue to be accommodative and the Bank of Japan will extend its zero-interest rate policy. Slower growth, lower interest rates, and lower inflation are historically good for EM sovereign debt. Given such macro conditions, we believe EM high quality debt will continue to outperform EM equities.

We also believe that conditions are right given recent economic and financial market performance for China and the U.S. to reach a constructive, if not final, outcome to trade negotiations during the first quarter. The combination of latent fiscal stimulus from last year's tax cuts, lower energy prices and a positive outcome from trade talks will allow the global economy to avoid recession in 2019. Given low expectations for growth from investors, this is likely to be a positive surprise through the first half of 2019.

There is likely to be increased volatility in financial assets. The correct course of action is to diversify, gradually reduce risk and add liquidity. Traditional fixed-income investors can diversify Treasury, corporate, and mortgage exposure by adding a diversified portfolio of hard currency EM sovereign bonds. For emerging market investors that translates into owning more investment grade sovereign bonds, less high-yielding sovereign and quasi-sovereign bonds and minimizing the risk from unwanted currency translations.

Investing is hard work. There is no mythical city where riches are easy to come by. Investors may have been fooled by central banks into the belief that they could achieve high returns without risk. The fact that most asset class returns were negative in 2018 should dampen the enthusiasm for that narrative. Adding non-diversifiable risk or sacrificing liquidity does not automatically guarantee an investor an excess return. Adding high quality assets that offer relative value to securities with similar risks to a portfolio may not be the most fashionable of investment ideas but at least it has a better chance of success in the long run than those that chase the momentum of the latest crypto craze or phantom FANG (Facebook, Amazon, Netflix and Google) return.