1167 CAPITAL

27/11/2018

The View from 1167 | A Question of Timing

It is a set-up to make the even coolest investor uneasy.

The global expansion has extended for the best part of a decade, with the economy of the world's hyperpower, the US, continuing to lead the developed market pack. But as a result, the Fed is now well into a hiking cycle – raising real interest rates on the world's reserve currency to levels not seen in years and pushing the US dollar into nosebleed territory against all the major crosses.

The periphery of the global financial system has been under pressure for two or three years. The emerging markets have been roiled by a series of headline-grabbing crises. Even the mighty East Asian growth engine has hit a rough patch.

Yet the US equity markets have continued to deliver, month after month, enjoying a bull market of almost unprecedented duration and intensity. The only catch has been the increasing reliance on the tech sector; and within tech, the narrowing to a handful of iconic stocks. Yes, the business models are untested through a full business cycle. Sure, the valuations look heady. But the price action has been unstoppable – and it's beaten all other asset classes hands down.

Until, that is, it does stop. The go-go stocks tank; the tech sector takes a bath; the broader US equity market corrects. The Fed's cranking up of real interest rates has started to bite, and the washback from the US dollar depth charge is finally crashing over the home shore.

All of a sudden, the questions on everyone's lips are what comes next – and where can I hide?

November, 2018? Indeed. But as it happens, the situation just outlined also describes the years leading up to, and just after, March, 2000 – the peak of the last US tech bubble.

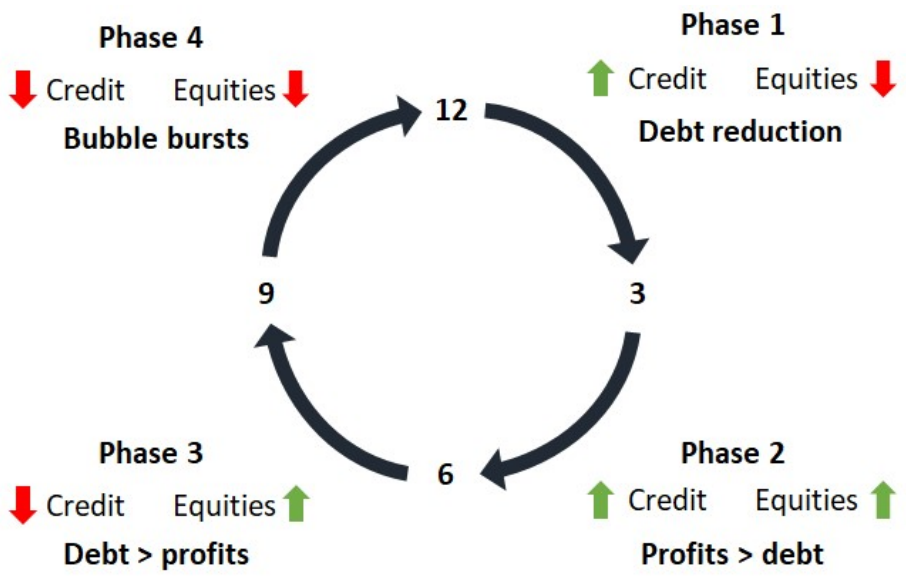
Unfortunately for us, Michael and I are both old enough to have professional memories of that period (Michael was even managing an EM bond fund just reaching its second birthday at the time…!). We don't subscribe to the view that history ever repeats itself exactly on the markets. Nevertheless, we do think that a comparison of today's situation with the 1998-2002 period can offer some useful insights into perhaps the most urgent question currently facing EMD investors: do current EM currency and bond valuations represent a significant buying opportunity – or does the prospect of further US equity turbulence mean EMD should remain a no-go area until the dust has settled?

The Citi Investment Clock: Sun Over the Yard Arm or Witching Hour?

For most investors, what is clear about the current situation is that the *economic* cycle is somewhat advanced – especially in the US, where the current expansion, at 113 months, is the second longest on record since 1945. What is less clear is where we are in the *investment* cycle – and what that means for asset prices and returns going forward.

A good summary of the current debate has been provided by two of Citi's top market strategists in a recent set of notes. Both ground their analysis in the framework of the "investment clock", as illustrated and explained in Figure 1 below. Where they differ (or differed until recently) is on what time it is.

Figure 1: The Citi Investment Clock



Starting at 12 o'clock, in the depths of recessions companies go through intense periods of restructuring in order to reduce their debt burdens. Assets are spun off, dividends skipped and equity raised in order to generate cash and reduce the risk of bankruptcy by paying down debt. Once this activity gets underway, credit spreads rally sharply — the risk of default is perceived to be past its peak — even though equity markets remain in the doldrums because issuance is dilutive and earnings continue to fall.

Eventually, cost cutting and aggressive restructuring, accompanied by economic recovery, yields a rebound in profits (after 3 o'clock). In this next phase, both earnings growth and debt/EBITDA are improving, causing credit and equity to rally together. However, as the cycle matures, this progressively gives way to a period of lower quality earnings growth, in which share gains are often achieved at the expense of corporate leverage, for example through acquisitions or share buybacks (after 6 o'clock). This keeps equities rallying, but deteriorating balance sheets start to drive credit spreads higher.

Finally, the resultant balance sheet deterioration comes to a head, creating a crisis in which profits cannot be sustained, and both equities and credit sell off (after 9 o'clock). It's time to take all risk trades off. This is usually associated with a recession which induces the retrenchment which eventually allows the cycle to start all over again.

Source: *For Whom The Clock Ticks: How Long Till End-Cycle*, Citi Research Global Multi-Asset View, September 4, 2018.

In September Rob Buckland, Citi's Chief Global Equity Strategist, made the case that markets are in Phase 3.[1] His reasoning is as follows. The outperformance of corporate credit by equity, and the narrowing of market leadership within the US market, are classic Phase 3 indicators. In the period since 2012, developed market QE deliberately decoupled credit spreads – which kept falling – from corporate leverage – which kept rising.

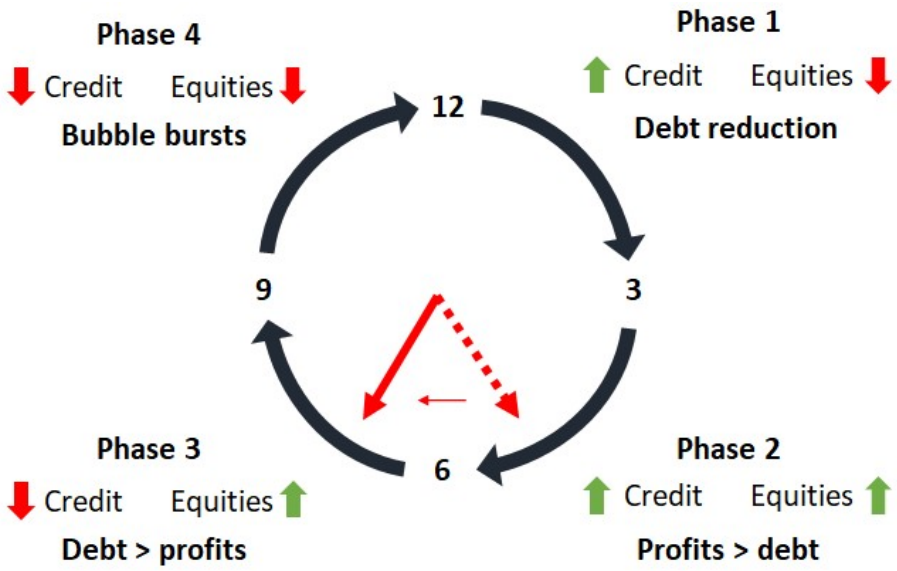
The result was that "even as balance sheets moved through 6 o'clock, so central bankers kept risk asset pricing back at 5 o'clock". With the imminent end of QE, however, has come the end of this

[1] For those with a subscription, Rob also published a summary of his argument in a Markets Insight column in the *Financial Times* on November 26, 2018 ("Why it's too early to call time on this ageing bull market")

artificial support for corporate bond markets. The investment clock has finally been allowed to move into Phase 3, with rising credit spreads and volatility beginning to hamper credit, but equities into their best period of the cycle.

In Rob's view – illustrated in Figure 2 – the Sun is finally Over the Yard Arm – with the implication that the party, for equities at least, may really only just have started.

Figure 2: Citi Investment Clock according to Rob Buckland, Chief Global Equity Strategist



Source: *For Whom The Clock Ticks: How Long Till End-Cycle*, Citi Research Global Multi-Asset View, September 4, 2018.

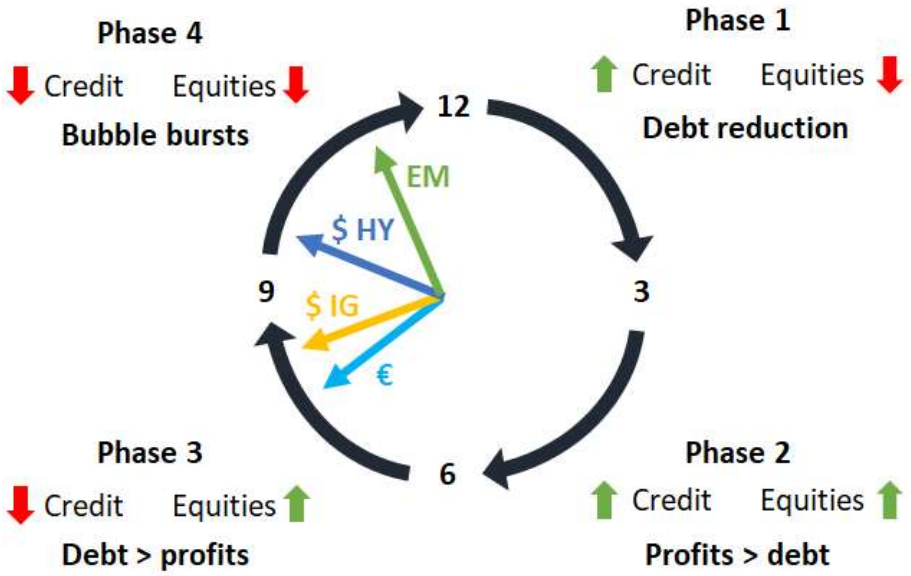
Matt King, Citi's Chief Global Credit Strategist, takes a different view – illustrated in Figure 3 below. He believes that markets are well into Phase 4. Matt's view is grounded firmly in fundamentals – in particular as they relate to the basic financial cycle of corporate leveraging and deleveraging set out in the explanatory text below Figure 1 above.

He argues that the current cycle progressed entirely normally in the global corporate sector until 2012. Profits grew faster than debt between 2009 and 2012. Since then, debt growth has exceeded profit growth. The result has been aggregate corporate leverage reaching levels never hit before, outside of recession (when the collapse in the denominator of the leverage ratio automatically sends it higher).

The anomaly in the post-2012 period is that credit spreads did not widen along with the more fragile balance sheets. That much was conceded by Rob above – but Matt points out that other regular market relationships also broke down. Equity volatility did not track rising policy uncertainty as it used to. Changes in consensus earnings expectations stopped correlating with equity prices. Like Rob, Matt identifies QE as the culprit – but his argument is that its withdrawal is exposing fundamentals that leave markets well into Phase 4.

For Matt, in other words, markets are approaching the Witching Hour – and both the global equity and credit asset classes are therefore acutely vulnerable.

Figure 3: Citi Investment Clock according to Matt King, Chief Global Credit Strategist



Source: *For Whom The Clock Ticks: How Long Till End-Cycle*, Citi Research Global Multi-Asset View, September 4, 2018.

The Emerging Markets: In a Different Time Zone?

The investment clock framework is not a formal part of our investment process at 1167 Capital. But it is an intuitive approach to the relative price dynamics of different asset classes for which there is evidence in practice and a reasonable explanation in theory. So we think it's useful to ask where EM sovereign bond and currency markets fit into the debate above.

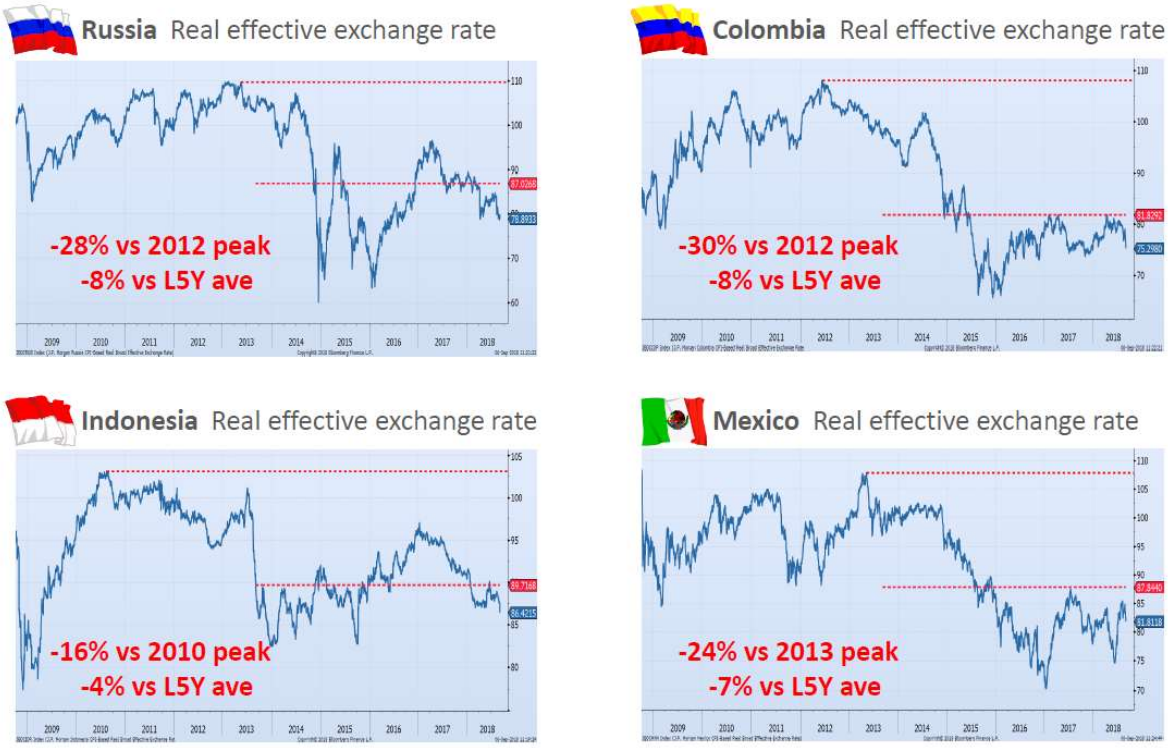
An interesting feature of Matt's reading of the investment clock illustrated in Figure 3 is that while he views developed market corporate credit as being still quite early in Phase 4 (or even, in the case of US dollar investment grade and euro-denominated credit, still in late Phase 3), he thinks EM equities and credit are much further advanced. Indeed, Matt's view is that for EM, the long, dark night of Phase 4 has been going on for so long already that it is already five to midnight. Of course, that implies a positive corollary: for EM, morning may be about to break.

There could hardly be a hotter topic in EM investing at the moment. Our sense from talking to current and prospective clients is that few investors dispute the fact that many EM asset classes are currently trading at potentially attractive valuations both relative to their own histories and other assets classes.

When it comes to stand-alone valuation metrics, they are often looking at the same kind of evidence that we presented recently at our recent Annual Investment Conference. As Figure 4 (taken from

Michael's conference presentation) shows, many major EM currencies trading well below their last-five-year averages, and up to 30% below their 2010-11 peaks, in real, trade-weighted terms.

Figure 4: Selected EM Real Effective Exchange Rates, Sept 2008 – Sept 2018



Source: JPMorgan / Bloomberg LLC as of September 6 2018. JPMorgan CPI-based Real Broad Effective Exchange Rates.

When it comes to relative value, meanwhile, they are often looking no further than the quite staggering divergence between the performance of EM and developed market assets over the past seven years. Over the period 31 October 2011 – 31 October 2018, the MSCI World Developed Market equity index returned +99.5% in US dollars, versus +16.7% for the MSCI Emerging Market equity index, for example.

Yet if there is a degree of consensus on valuations, there is much less agreement on two other questions:

1. How vulnerable are *other* risky asset classes – most prominently US equities and credit – to the continued withdrawal of G4 central bank stimulus?

2. If the answer to 1 is that US equities and credit may suffer a significant de-rating, then will that not inevitably trump EM valuations and lead to further weakness in EM returns?

If the investment clock itself is a valid framework, and EM really is as far ahead of DM asset classes as Figure 3 postulates, then the answers to these two questions are that:

1. Returns to US equities and corporate credit may indeed disappoint in the coming period; but that

2. EM assets, by virtue of being furthered advanced in the painful economic and investment cycles, may nevertheless be able to outperform.

If correct, this is clearly a prognosis of significant interest to investors. So how convincing is it?

Is This Time That Different?

My guess is that for some investors, it will seem difficult to believe, not least because the recent QE-saturated period has been characterised by a regime in which "risk-on / risk-off" market dynamics have been quite closely correlated across different asset classes. Along with a significant number of others, we are not so sceptical, however. One important reason for this is the track record of how asset classes behaved during the last tech-driven boom-bust cycle of 1998-2002 – the comparison with which I began this note.

If we separate that period into two stages – the first leading up to the peak of the Nasdaq Composite Index on March 10, 2000, and the second from that peak to the trough of the subsequent bear market on October 4, 2002 – we find the following:

Table 1: Total Returns to Selected Asset Classes, Dec 31, 1997 – Oct 4, 2002

Asset class	Total Return		
	Dec 31 1997 – Mar 9 2000	Mar 9 2000 – Oct 4 2002	Dec 31 1997 – Oct 4 2002
US Tech	+223.7%	-77.2%	-26.3%
US Equities	+48.8%	-40.9%	-12.1%
EM Equities	+34.9%	-45.3%	-26.2%
US Treasuries	+9.3%	+32.4%	+47.7%
EM Hard Currency Sovereign Debt	+15.9%	+23.0%	+44.7%
EM Local Currency Sovereign Debt	+34.8%	+9.6%	+42.5%

Indices: US Tech = Nasdaq Composite; US Equities = S&P 500; 030918EM Equities = MSCI Emerging Market Equities; US Treasuries = JPMorgan US Treasuries Index; EM Hard Currency = EMBI Global Diversified; EM Local Currency = JPMorgan ELMI+. All returns calculated using total return indices provided by Bloomberg LLC.

I should begin by bombarding the table above with provisos. The periods chosen are arbitrary, except for their stated relations to the boom and bust in the Nasdaq Composite Index. The composition of several of the indices used differed markedly in the periods reported from today (and in the case of EM LC Sovereign Debt, the JPMorgan GBI-EM index family had not even been initiated, so I have had instead to use the earlier standard JPMorgan ELMI+ Index, which was and is restricted to short duration bonds and bills only). And of course, the global economy looked very different in 1998-2002 to how it looks today. Nevertheless, I think it is reasonable for investors asking the two urgent questions above to draw a few basic conclusions.

No doubt the most striking one is that given the right initial conditions, it is perfectly possible for EM fixed income markets to decouple dramatically from US equity markets and so to deliver not only material relative outperformance, but positive performance in absolute terms, even as those same US equity markets sustain a deep and prolonged bear market. As I tried to suggest in my introduction, investors will find this conclusion all the more relevant to the extent they believe that the defining

features of today's US equity bull market, and the US Federal Reserve's response to it, are similar to those in the late 1990s.

Another conclusion is that the idea that EM equities and EM LC sovereign debt should be treated as close substitutes in portfolios can be very misleading. Table 1 shows that while both asset classes do obviously share an important factor in their exposure to local currency risk, their performance can diverge spectacularly. In the post-peak period of Table 2, local currency exposure was a drag on performance for both EM equities and EM LC sovereign debt (i.e. the US dollar strengthened against EM currencies). The critical difference was that for EM LC sovereign bonds and bills, the high yields paid out more than compensated for this and compounded to deliver a healthy positive total return in US dollar terms; whereas for EM equities, currency losses were exacerbated by low dividend yields and shrinking multiples.

A final conclusion relates to the relative dynamics of EM Hard Currency (HC) and LC sovereign debt respectively in the context of a US equity bear market. A quick comparison with the US Treasuries row in Table 1 reveals that the positive EM HC returns in the post-peak period were to a large extent a function of a sizeable rally in the US yield curve. Indeed, the fact that the returns from EM HC bonds were lower than those from US Treasuries indicates that credit spreads actually widened over that period. It is notable, however, that this increase in the implied default risk on EM HC sovereign bonds did not translate into negative returns on EM LC bonds. That should not be altogether surprising, since the two kinds of EM sovereign bonds offer exposure to – and so returns driven by – different kinds of risk: *credit* and *US dollar duration* risk in the case of EM HC bonds, and *currency* and *LC duration* risk in the case of EM LC bonds.

Cometh the Hour, Cometh the Asset Class: EMD in 2019?

To reiterate: these conclusions should not be regarded as hard-and-fast statistical regularities that can be used to predict asset class returns and their relation to one another or to economic fundamentals. They are drawn from a sample of one, after all.

What the 1998-2002 period does demonstrate, however, is something more modest – but I suspect no less surprising to many investors. This is simply that the market reaction to rising US real rates and a stronger US dollar can combine both a severe bear market in US equities and a healthy positive performance from EM sovereign bonds.

The prognosis suggested by the Citi investment clock framework, in other words, is not far-fetched as it might sound. If the tightening of US financial conditions is indeed beginning to put a stop to the glorious bull run that US equities and credit have enjoyed over the past nine years, and the playbook of the last tech boom and bust is relevant, it is just possible that Emerging Market bonds may be one of the asset classes whose time it is to shine.

Felix Martin

Partner and Fund Manager, 1167 Capital

Important Notice