20/03/2020

The View from 1167 | Blood in the Streets

The road from March, 2019

On Friday, 22nd March 2019, the US yield curve inverted for the first time since August 2007. As you will know from our communications over the past year, we saw this as a key event – because such an inversion has never failed to predict a US recession within the next eighteen months. It therefore suggested to us that the US, and therefore the global, economy was fragile and vulnerable to a shock – whatever that shock might be.

This fundamental change in outlook formed the basis for our subsequent investment approach. We began to aim off by:

1. **Reducing/avoiding credit risk**. In fact we have been a little short in EM sovereign hard currency and Turkish risk and recently unwound it at a profit.
2. **Maintaining no exposure to corporates**. Corporate bonds tend to carry the most vulnerable type of credit risk in a sustained downturn.
3. **Reducing/avoiding exposure to sovereigns with high debt models.** High debt levels often lead to fiscal problems in downturns (e.g. no Argentina, no Brazil).
4. **Reducing/avoiding exposure to frontier and less liquid sovereigns.** E.g. we sold out of all exposure to Egypt and Ukraine in the frontier space, and reduced exposure to the Dominican Republic in the less liquid index-eligible space.
5. **Reducing duration**. Longer dated bonds do worse than shorter dated bonds in sharp downturns because EM bonds are not regarded as safe havens by foreign portfolio investors (even though they often are by local institutional investors). We have steadily reduced portfolio duration from over 8 a year ago, to around 4 by the end of 2019.
6. **Generally simplifying the portfolio.** Complexity is one of the biggest enemies of clear decision-making in a crisis. We have been reducing the number of positions and focusing exposure on the more liquid area of bond curves in the more liquid countries
7. **Increasing non-USD exposure**. With the US dollar historically expensive in real terms, and the Fed with more leeway than other G10 central banks to loosen monetary policy, there is a significant risk that a US economic downturn will ultimately result in dollar weakening as currencies re-align with long-term valuation relationships. We especially began to put more emphasis on currencies in central Europe (CZK, PLN) that are likely to be highly responsive to such a scenario.
8. **Keeping powder dry for opportunities.** We have built up cash and near-cash equivalents (e.g. short term US Treasury bills) to 20% to 25% of NAV.

Taking these steps has helped in this downturn. From the end of 2019 to 18th March 2020, the 1167 Global High Income Bond Fund is almost 4% points ahead of the market, while the 1167 Global Total Return Bond Fund is almost 8% points ahead.[1]

[1] Source: Bloomberg. Funds: A2-USD share classes; market: JP Morgan GBI-EM GD Index.

Crisis dynamics

As investors through many minor and several major crises over the past three decades, we have learned what we believe to be some important lessons about how they typically evolve:

1. **Credit (e.g. US dollar- and euro-denominated bonds) does badly.** This is true of both sovereign and corporate credit; but it is particularly true of corporate bonds. This happens not only because the risks of default rise, but also because these markets are small, illiquid and have narrow sponsorship.[2] This makes them desperately hard to sell under duress, except at significant discounts. Having no credit risk is very helpful at the moment.

2. **The local currency bonds and currencies of sovereigns with strong fundamentals do better than those with weak fundamentals, especially in the early stages.** So, for example, in January this year the Indonesian rupiah (which we held) did very well, while Brazilian real and South African rand (neither of which we held) did very badly.

3. **If the crisis accelerates, it is not uncommon to see indiscriminate selling of good and bad countries.** This is what has happened this month. Local currency sovereign bonds and currencies of almost all sovereigns have been hurt. Such indiscriminate selling is often due to funds being forced to sell and/or leveraged investors shorting these more liquid instruments in order to hedge less liquid assets such as hard currency sovereign and corporate bonds that can’t easily be sold. Furthermore, the long end of local currency sovereign curves has been sold more aggressively as investors reduced duration risk, in spite of US Treasury yields falling. So for example in Mexico, Russia and Indonesia (good countries) not only have local yield curves steepened dramatically, but their currencies have also fallen substantially.

4. **This is typically the stage where significant opportunities arise – because it is when potential overshooting occurs in the bonds and currencies of sovereigns with strong long-term fundamentals.** It is no surprise that it is these instruments that typically recover fastest too. This point is crucial. Coming out of major crises, many assets, such as corporate credit and weak or frontier sovereigns, can be slow to “bounce” - a phenomenon one of our clients many years ago referred to as the “wet newspaper” effect. The bonds and currencies of larger, more liquid EM sovereigns with strong long-term fundamentals, by contrast, offer not only the chance to lock in unusually high yields at cheap currency valuations, but the potential for sharp capital gains as shorts scramble to cover and the impact of forced sales abates.

Blood in the streets

As an illustration of the opportunities currently arising, the following table shows, for a selection of countries, yields on a selection of 10 year local currency sovereign bonds at the end of 2019 and at 18 March 2020, with changes, together with the declines in bond prices and currencies against the US dollar:

[2] Size of asset classes, JP Morgan CEMBI Monitor 31/01/20: EM HC Sov $1.2tr, US HY Corps $1.6tr, EM HC Corps $2.4tr, EM LC Sov $10.2tr.

	10y YTM 31.12.19	10y YTM 18.03.20	Change in YTM	Change in Bond Price	FX vs. USD
Brazil	6.8%	8.6%	+1.8%	-12%	-21%
Colombia	6.3%	8.2%	+1.9%	-13%	-20%
Mexico	6.9%	8.3%	+1.4%	-9%	-20%
Russia	6.4%	8.4%	+2.0%	-13%	-23%
Indonesia	7.0%	7.6%	+0.6%	-4%	-9%
South Africa	9.0%	11.3%	+2.3%	-14%	-18%

These are substantial rises in bond yields, and falls in bond prices and currencies, which have occurred over a very short space of time. We have avoided some of the worst (Brazil) and we have been invested in some of the best (Indonesia). They open up the possibility of locking in mainstream EM sovereign bond yields in the 7.5% to 11.5% range for a multi-year period, at exchange rates which have already fallen significantly.

One of the oldest dictums in the market is that the time to buy is when there is blood in the streets. Yet as experience teaches, that is a lot easier said than done.

There are two reasons why it is so hard to put into practice:

1. **You need to have the space to increase risk.** This is hard if you have no cash and/or too many illiquid or badly performing investments that distract you from the opportunities being presented in more traditional assets.

2. **The news flow is awful.** It is easy to forget that if you want assets at lower prices, you have to accept that those lower prices only come on the back of unfriendly news. There is no free lunch, as they say. The relevant question is always: "Do these lower prices sufficiently discount the increased risks?"

It is not particularly contentious to suggest that there is presently blood in the streets. Our preparation ahead of this downturn has offered us the space to focus on the potential opportunities. Just as a large part of our preparation was in simplifying the portfolio, so taking advantage of these opportunities will focus on relatively simple changes as well: (i) deploying cash; (ii) extending duration; and (iii) increasing currency exposure.

As for the news flow: we believe that the lower prices in our world sufficiently discount the risks, so we are inclined to begin implementing one or more of the above. In doing so, we will stick to our preferred sovereigns, focusing on those (i) that have better fundamentals; (ii) that are liquid; and (iii) that we expect to bounce hardest in a recovery.

Michael Mabbutt

Partner and Fund Manager, 1167 Capital

20/03/2020

Update – remote working

Further to Matt's Service Delivery update of 12th March, and as detailed therein, please note that we have now taken the decision to work remotely. All contact details remain the same. If you intend to post any document to us, please also send us a scanned copy by email to sales@1167capital.com.

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