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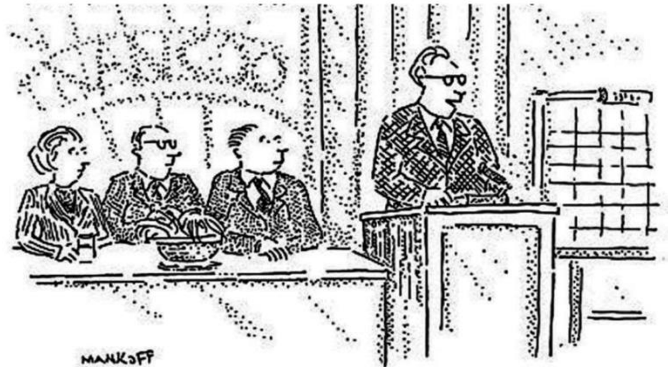
From bah humbug to happy holidays!

May 2019

By Neil Sutherland, Portfolio Manager, Fixed Income

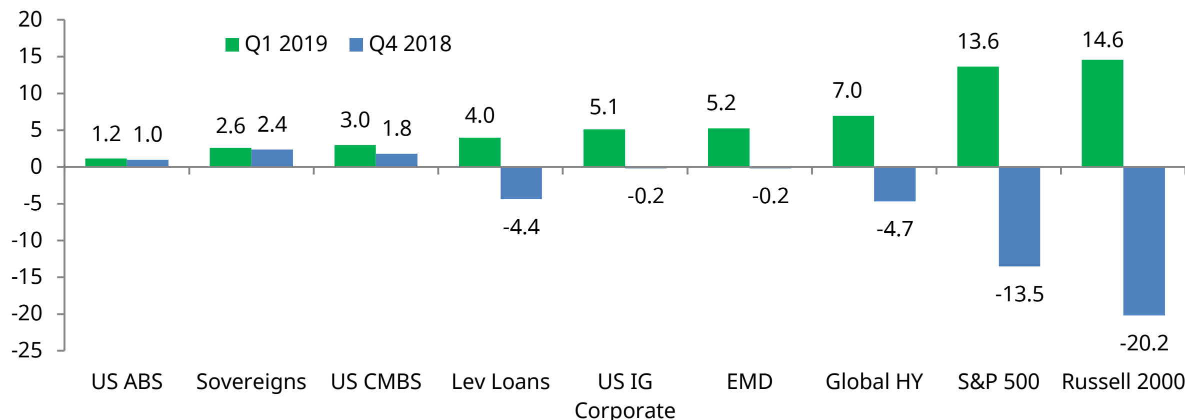
Ebenezer Scrooge was the chief protagonist in Charles Dickens classic novel from 1843, *A Christmas Carol*. At the beginning of the novel, Scrooge is a cold-hearted miser who despises Christmas. After visits from the three Ghosts of Christmas, Scrooge transforms into a model of generosity and kindness. In gifting a goose to his maligned clerk, Bob Cratchit, and paying the medical expenses of the clerk's son, Tiny Tim, he transforms Christmas for the Cratchit family.



"And so, while the end-of-the-world scenario will be rife with unimaginable horrors, we believe that the pre-end period will be filled with unprecedented opportunities for profit."

So what does a Dickens have to do with financial markets in 2019? Our chief protagonist in markets recently has been Jerome Powell and his remarkable transformation also took place over the holiday period. At the tail end of last year, he was chief market curmudgeon, declaring we were "a long way from neutral", creating a miserable holiday season for risk assets as the S&P dropped almost 20% from the end of Q3 2018 through Christmas Eve. However, his astonishing pivot in recent weeks, where he suggested that rates might have already peaked, led to the best end of the Christmas period and new year for risk assets and stocks since 1987. With the S&P returning over 21% from Christmas Eve through March 2019, even the Cratchit's didn't have it this good!

Figure 1: Q1 2019 vs. Q4 2018 Total Returns (%)



Source: Bloomberg, as of March 2019. Performance shown reflects past performance, which is no guarantee of future results. The value of investments can go down as well as up and is not guaranteed. Investors cannot invest directly in any index. Actual results would vary due to, among other things, fees and expenses.

Less spice and more stodge

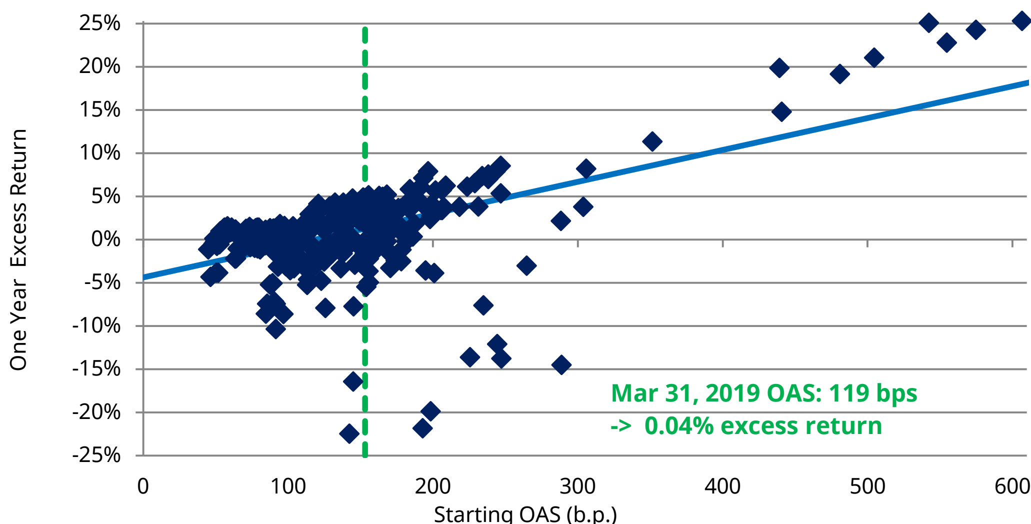
Although we took the opportunity to add back some risk in early 2019, we believe caution is warranted in today's environment. Indeed history indicates significant bear market rallies are the norm after such a significant downdraft. In the following sections, we outline our rationale that the appropriate asset allocation in our bond portfolios is very different from the post-crisis era. We have significantly less corporate and municipal exposure, but meaningfully higher securitized and Treasury allocations than we have had in several years. We believe fixed income returns in Treasuries and securitized are likely to be better supported both in coming quarters, as the Fed's hiking

cycle draws to a close, and challenges to the global growth environment continue to build headwinds longer-term. However, the relative value in riskier spread sectors looks much more compromised an unrewarding.

Valuations – the gift that won't keep on giving

Adequate compensation for risk has remained a core tenant of our investment process for decades, and today valuations in riskier sectors offer very little room for disappointment. Figure 2 tracks 25 years of index data and demonstrates historically when investing in investment grade corporate bonds at current spreads relative to Treasuries you have hardly been compensated (+4 bps of excess returns). Historical data is of course not predictive, but it is a good starting point for us to frame longer-term opportunities across higher risk fixed income sectors relative to Treasuries.

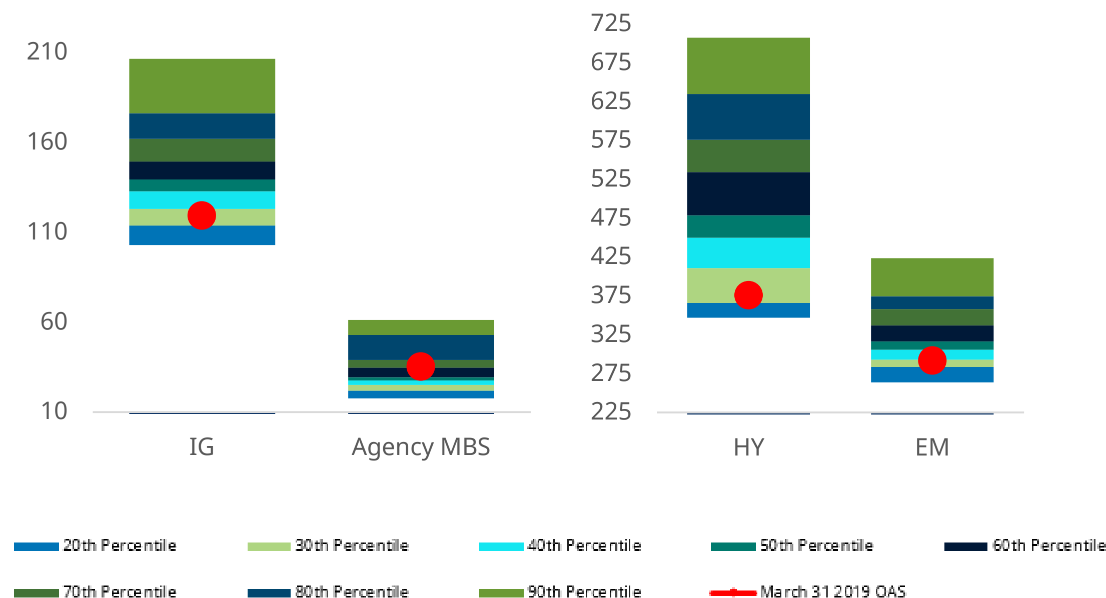
Figure 2: US Corporate Investment Grade: 1-yr Excess Return vs. Starting OAS



Source: Schroders, Bloomberg as of March 2019.

Another way to look at value is to monitor spread percentiles through time, or where different sectors currently trade relative to their long-term history. Below you can see average percentiles for investment grade credit, mortgages, high yield, and emerging markets over the last 10 years. The spreads have been wider more than 75% of the time for high yield; 60% for emerging markets and investment grade credit; while Agency MBS is closer to average.

Figure 3: Current percentile of OAS (bps) over last 10 years



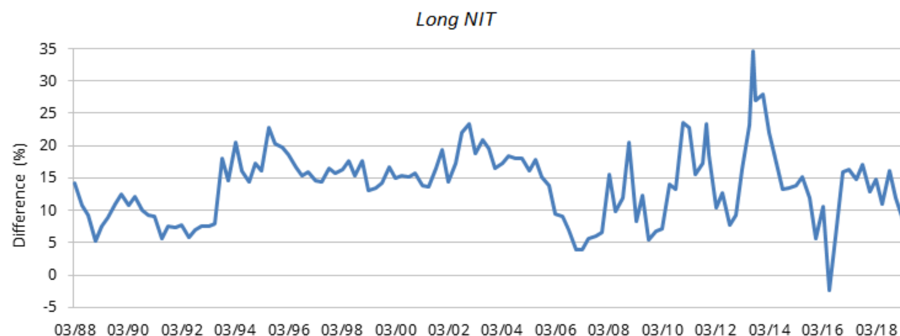
Source: Schroders, Bloomberg as of March 2019. Indices are reflected as follows: IG is Bloomberg Barclays US Corporate Index; Agency MBS is Bloomberg Barclays US MBS Index; HY is Bloomberg Barclays US Corporate High Yield Index; EM is Bloomberg Barclays Emerging Market USD Aggregate Index.

We do not have perfect foresight, no one does, and maybe the liquidity-fueled euphoria can push credit spreads to new cycle lows. However, with growth slowing, earnings having most likely peaked, and a number of late cycle indicators at least flashing amber, we caution chasing returns. One of the great strengths of our approach is clients allowing us the flexibility to wait for opportunities, rather than reaching in risk sectors when opportunity is limited and compensation is historically unattractive.

The Todd Jewett Indicator – he timed it well

A quick comment on Municipals and our beloved colleague, Todd Jewett. As you are all aware, Todd retired at the end of March after a storied 42-year career, which included 25 years with STW/Schroders. He will be missed by all of us, but be assured his keen sense for value continues to resonate throughout the team. Todd was the architect of our relative value model for taxable versus tax-exempt bonds: the NIT or net implied tax rate (Figure 4).

Figure 4: Net Implied Tax Rate (NIT)



Source: Schroders, Bloomberg as of March 2019. The NIT reflects the relative valuations between long-duration tax-exempt municipals and similarly rated corporates.

At current valuations, this model is suggesting very limited value for municipals versus taxable bonds. This is reflected in our taxable strategies where we have the lowest allocation to municipals and highest to taxable bonds in a number of years. Even with the tax exemption, we expect after-tax returns in municipals to be ordinary on a relative basis over the next few months. Other measures, such as the ratio versus Treasuries, suggest municipals are close to the most fully valued in 25 years. As we wish Todd well, it is amazing to consider he started his career when spread sectors were cheap and bonds had double-digit yields. His timing may be impeccable.

Central banks got our back, bring back the punchbowl!

Now that central banks have relented on some of their more hawkish rhetoric, does that mean a return to the liquidity fueled bull market is set to continue? We observe today's backdrop is vastly different from the recoveries central banks fueled post-crisis and in early 2016 for three reasons:

1. Growth trajectory
2. Liquidity isn't expanding nearly as aggressively
3. China in particular is no longer in a position to bail out growth in the rest of the world

In early 2016 global growth had troughed, followed by an unprecedented nine consecutive quarters of accelerating real GDP year-over-year growth in the US. Today we find ourselves in a different environment where even the most optimistic prognosticators are expecting US growth to stabilize at lower levels, with the risks skewed to the downside.

The International Monetary Fund (IMF) recently downgraded global growth to its lowest rate since the financial crisis. European growth this year is barely above zero, with Italy already in recession and Germany recently posting its worst PMI since 2012. In Asia, Chinese data may stabilize from recent softness, but growth is expected to be at its lowest since 1990. Japan's tankan survey (a measure of business confidence) recently posted its lowest reading in six years and South Korea, a global bellwether, saw its exports drop 8% year-over-year. Central banks to the rescue? They may be bringing a water pistol to a gunfight.

Liquidity, a proxy for the amount of funds that are globally available to flow into financial assets, will no longer serve as the tailwind we experienced in recent years. Liquidity is often one of the most misunderstood, but important, drivers of financial market performance. In our view, liquidity played a huge part in contributing to outsized gains for financial assets in recent years. Although recent announcements by central banks indicate continued accommodative conditions, liquidity is unlikely to expand to the historically massive levels we witnessed in the post-GFC years.

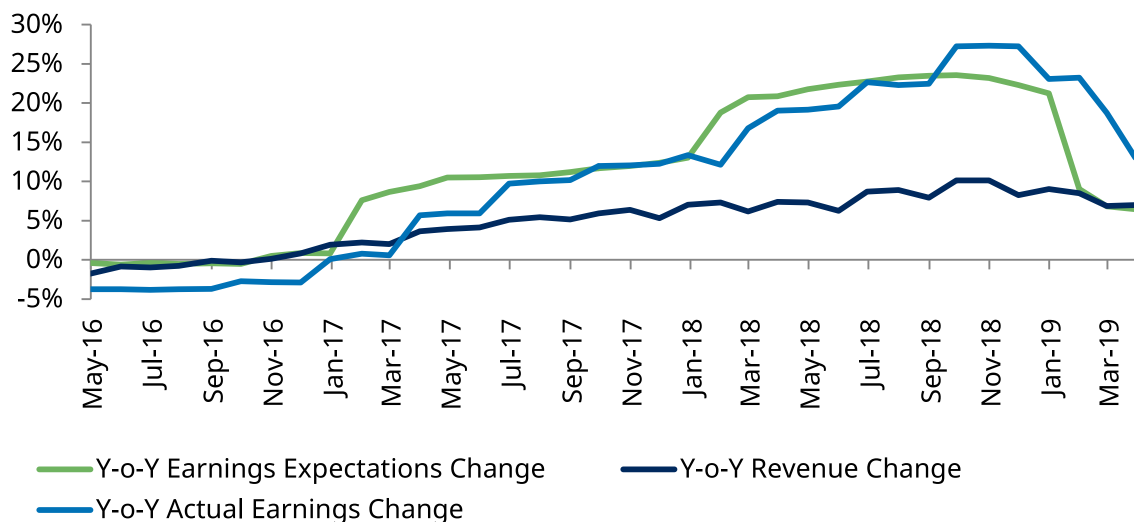
As it relates to China, they undertook colossal fiscal stimulus in the immediate aftermath of the crisis and again in 2016. China alone contributed close to 40% of global GDP in 2016. They are no longer in a position to do this. The current account surplus, which allowed them to pump excess capital into global markets, has all but vanished and with the fiscal deficit expanding and reserves shrinking, they are no longer in a position to be the lender of last resort.

Markets have been conditioned in the post-crisis era to gyrate to every utterance of central bankers, believing they will always be there to limit any downdraft for risk assets. So far this has worked. However, with rates outside the US already negative and US growth trajectory at best mixed, the biggest challenge for markets may come when the infallibility of central banks is questioned. We believe this moment is closer than presumed.

The market reaches new highs—the fundamentals must be great

The backdrop for corporate earnings is becoming considerably more challenging. Lower revenues, increasing margin pressure from higher input costs (including labor) as well as lower buybacks will provide increasing headwinds. In Figure 5 we can see EPS estimates for the S&P in 2019, after the breakneck rate of last year.

Figure 5: S&P 500 Earnings Expectations vs. actuals (% change year-over-year)

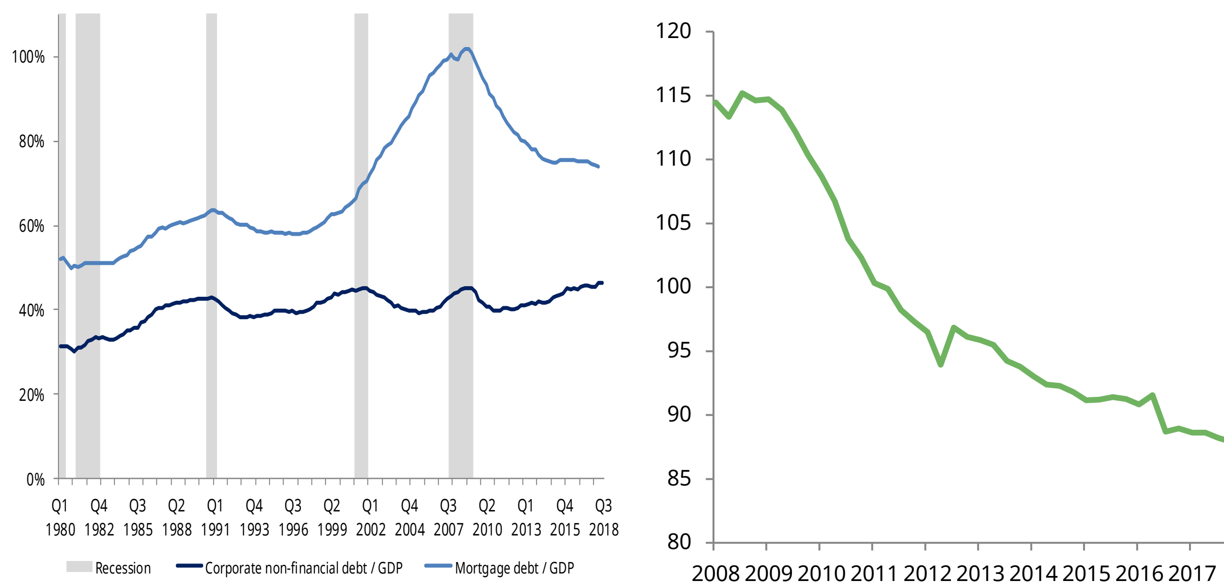


Source: Bloomberg, as of March 2019.

We have been enthusiastic credit investors for most of the last 10 years, now we are more circumspect. Credit cycles follow a somewhat predictable sequencing, with balance sheets going through a periods of expansion, to downturn, to repair and finally to recovery. Currently, we believe we are transitioning from the expansion to downturn phase, historically the most perilous time for investors in credit.

A feature of the post crisis era has been the explosion of debt on corporate balance sheets, but relative discipline of on the part of consumers. Corporate debt outstanding has almost tripled over the last 10 years while consumer debt has been virtually static. Sectors that grow exponentially in bond indices should engender caution especially when accompanied by deteriorating underwriting standards and yield chasing behavior; it normally does not end well. Corporate debt growth has grown significantly ahead of GDP, revenues and earnings. We have reached a point today relative to GDP which has previously created market stresses.

Figure 6: US corporate and mortgage debt as % of GDP vs. Household Debt to Personal Income (%)

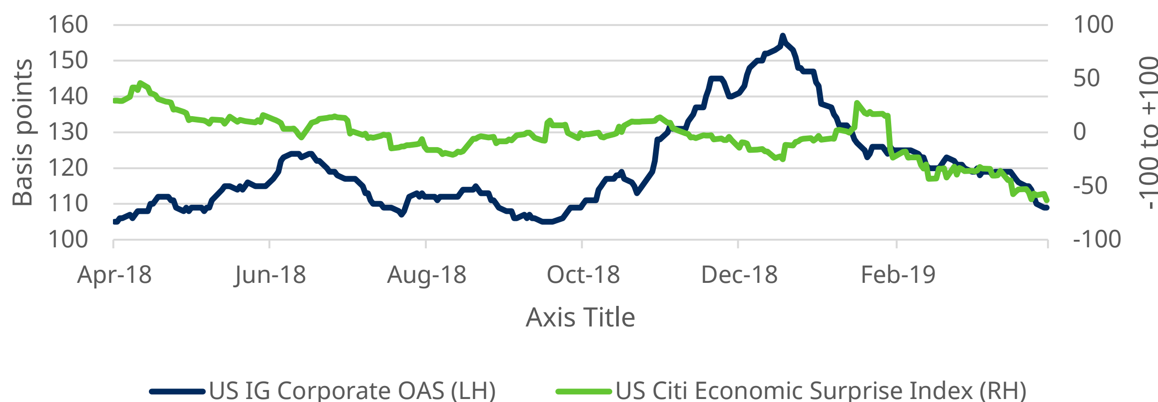


Source: Federal Reserve as of January 31, 2019, MBER. Shaded areas reflect recessionary periods.

With fundamentals and valuations much more appealing on the consumer side, we have been increasing our exposure to the securitized sector across all of our portfolios. Mortgage-backed securities presently offer better liquidity and credit characteristics than corporates, and a higher current yield than comparable-maturity Treasuries. With attractive all-in yields, strong fundamentals and less reliance on foreign sponsorship, it's a sector we continue to build, and should prove more resilient as we transition into a more challenging economic and risk taking environment.

"In the short run it's a voting machine, in the long runs it's a weighing machine." —Benjamin Graham

Figure 7: US Corporate Spreads vs Economic Surprise Index



Source: Bloomberg, as of March 2019.

Technicals can drive markets for prolonged periods as we have seen in the post-crisis era of financial repression. Ultimately; however, fundamentals do come to bear. As we saw late last year, market stresses evolve slowly at first and then all at once. When combined with the pressure on earnings and elevated leverage levels, this creates a very unstable equilibrium especially when central banks are running out of ammunition. There is also increasing evidence that the economic cycle may be approaching its twilight. Late cycle indicator lights are flashing and Powell's benevolence can't prolong Christmas indefinitely.

The economy depends about as much on economists as the weather does on weather forecasters.

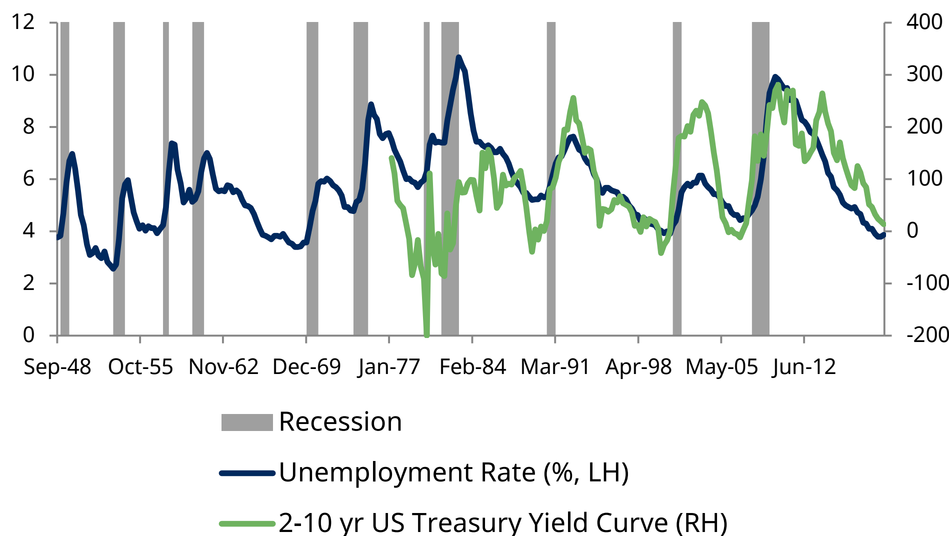
Much has been written about the length of the current economic expansion, which will be 10 years old this summer. This will be the longest on record and compares to an average post-war expansion of five years. However, we are mindful of the adage that economic

expansions do not die of old age. Trying to forecast recessions is a fool's errand and economists, and especially the Federal Reserve, have been spectacularly unsuccessful in doing so. However, historically two of the most reliable indicators in anticipating a transition in the economy have been the yield curve and the unemployment rate. Both suggest that while a downturn may not be imminent, we should at least be thinking about a transition in the economic cycle.

Yield curve

The spread between 10-year Treasuries and 3-month T-bill inverted last month for the first time since late 2007. Although its usefulness in extrapolating the exact timing of a downturn (anywhere from 6-18 months afterwards) is less exact, the inversion has preceded every recession since the late 1960s (Figure 8). Yield curve indicators are frequently dismissed prior to regime shifts for a variety of reasons, currently negative yielding debt overseas is the rationale. Maybe that is right, but the yield curve has a far better track record than most economists to date.

Figure 8: Yield Curve and Unemployment vs. Recessions



Source: Bloomberg, as of March 2019.

Full employment—careful what you wish for

Along with the yield curve, the St. Louis Fed identified a trough in the unemployment rate as a reliable indicator of a business recession. The current unemployment rate is close to a 50-year low at 3.8%, having dropped to as low as 3.7% in September last year. Although broadly speaking the employment picture remains supportive for now, in order for growth to accelerate more labor needs to be drawn into the labor force. For growth to increase, the best unemployment scenario is high and falling, not low and stable or rising. This is particularly true today as growth in the working age population dropped from 1.5% annually in the late 1990s to barely above zero today. With wages approaching post-crisis highs, it suggests labor shortages are an issue. Historically when the unemployment rate has dipped below 5%, the 5-year forward returns for the S&P Index have been negative.

Figure 9: Five-year forward returns are negative when unemployment is below 5%

Source: Bloomberg, as of March 2019. Past performance is no guarantee of future results.

Investing in a higher volatility and lower return regime

The volatility and pace of the downturn late last year was remarkable in its velocity and magnitude. Equally impressive has been the retracement year-to-date. In hindsight, we wished we had added more risk earlier in the year. However, our analysis suggests we underwent a regime shift over the course of 2018 and the central bank induced rally we have experienced post the correction is not unusual. With the global liquidity backdrop remaining challenged, economic growth and corporate earnings slowing, leverage extended and central bank ammunition depleted, we believe the investing landscape remains fragile. In contrast, we believe the outlook for higher quality, particularly short maturity fixed income, looks more positive than it has for a number of years. We believe the Federal Reserve hiking cycle is likely behind us and Treasury yields should remain well supported.

After the best first quarter for risk assets in 20 years, and fixed income spread sectors once again trading towards the most expensive end of their 10 and 20 year ranges, we believe the appropriate asset allocation remains one of cautious optimism and safer carry. This implies less corporate risk, less municipal exposure and more liquidity or carry in the form of Treasuries and securitized debt. This is not a time to force positions; it is a time for patience and opportunism.

Christmas cheer may not last forever despite the best efforts of Mr. Powell.

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