Ten Seconds Into The Future. 2015 Macro and Investment Outlook

Themes: Risk On and Pray Hard.

Rates and Credit:

Long US treasuries at the long end. 30 year and 10 year USTs remain attractive relative to short end. Expect further curve flattening.

Overweight / Long China equities. Despite slowing economic growth, earnings growth remains robust and the PBOC will likely be expansionary and China equities are cheap compared with most international equity markets. Longer term prospects are supported by structural reform.

Developed market credit is still attractive but investors have to be selective. Despite healthy profits and balance sheets, US corporate credit is expensive and high yield particularly so.

European corporate credit remains attractive based on fundamentals but pricing is also getting stretched. We prefer idiosyncratic situations such as regulation driven bank recapitalization trades.

European bank capital is a trade which is long in the tooth but remains attractive as ECB policy supports the recapitalization and reorganization of bank balance sheets.

The leveraged loan market is underpinned by healthy fundamentals but secondary market liquidity is becoming a concern. Fundamentals remain healthy with default rates likely to be in the 2% region with high recoveries in the coming year. The risk of a sharp correction is significant but such should be regarded as a buying opportunity.

In securitized products, US non agency RMBS remains an attractive asset class despite the trade being long in the tooth. Agency RMBS derivatives are cheap and can be used to also hedge a long duration portfolio. Australian RMBS has done well but bonds are now expensive. European ABS and covered bonds will be underpinned by the ECBs asset purchase programs.

The thirst for yield has caused the high yield market to run ahead of itself. Generally, globally, we prefer investment grade to high yield on a relative value basis as high yield is now trading tight to investment grade.

Underweight LatAm equities and corporate bonds. With the exception of Mexico, the region is in or close to stagflation on the back of over-reliance on China demand for commodities and failure to reform or a regression towards inefficient and populist policies.

Equities:

US equities are not cheap but they are supported by strong fundamentals. Relative to other regions, US equities have the advantage. While a long term buy, valuations are too rich. To buy US domestic risk, look to credit. High yield is similarly expensive, however, so focus on private label mortgages and investment grade corporates.

China equities will benefit from the PBOC’s newly accommodative stance. Despite strong growth and cheap valuations, China equities have been constrained by tight monetary conditions at home. This is already changing with noticeable effect. Buy the domestic listings.

European equities were cheap but no longer. The international nature of European equities and the level of dispersion in their financial performance means that Europe is an excellent place to generate alpha. The rate and policy environment do, however, recommend corporate credit ahead of equities as the more efficient trade expression. In Europe, underweight equities in favour of credit.

Reform countries including India, Indonesia and Japan will be well supported as investment is revived. Where corporate governance lags the developed markets, side with business owners and own the equity instead of the debt.

FX and Commodities:

The long USD trade has become an alarmingly consensus trade. While the long term fundamentals are constructive for the USD, volatility is picking up and a trading strategy is recommended. The obvious candidates to short are the EUR and JPY where policy is decidedly in favour and economies are sufficiently weak that the US will tolerate the clearly mercantilist policy.

China's slowdown may be more pronounced than reported or expected. This will likely trigger more infrastructure investment boosting basic materials and industrial metals.

Macroeconomic Environment

The US economy is on a new long term growth trajectory, however, the pace of long term potential growth is lower than it was before 2008 when private sector credit creation was rampant. Under new financial regulations such as Dodd-Frank, Basel 3 and various other bank capitalization rules, economic growth will likely be subdued. The market is overestimating the long term potential growth rate leading to cyclical mis-estimation of spot growth rates. This theme will provide short term trading opportunities in the US. The current phase in the cycle is strong suggesting potential slowing in 2015.

Europe's single currency will lead to economic inefficiency, specifically to non clearance of goods, factor and asset markets where prices are unable to adjust or adjust quickly enough. Case in point in labour markets where complex labour laws stymie local price discovery and the lack of domestic currencies lead to failure of the market to clear, i.e. unemployment. Regulated markets will similarly fail to clear facing either over or undersupply. These fundamental flaws will create periodic crises of varying scale providing excellent trading opportunities. The current phase in the cycle is slow which suggests potential for improvement in the coming year.

Reform Countries: Japan, India and Indonesia are countries in various stages of significant structural change. Japan's experiment began earlier than the latter two and will be instructive. Current signs are positive that the country will achieve its reform objectives, albeit with some uncertainty and turbulence around political will and support for difficult policy choices.

China's economy continues to slow steadily from an energetic 7+% this year. Apart from base effects, one reason is that unless one is the generator and owner of intellectual property, one's economy is hostage to being a low cost producer. When costs rise, business moves migrates, and costs have been rising. China has long had a technological disadvantage compared with the West and it clearly recognizes this. The number of patents filed by Chinese firms has accelerated recently relative to the rest of the world. Most exciting about China are incipient signs that the government is shifting from disorganized central planning to organized institutional governance and control as a prelude to greate decentralization. The elevation of the constitution at the Fourth Plenum in 2014 is one of the most important developments in China in recent times but has been discounted by most market cynics. It should not be.

Latin America has been flirting with stagflation and regression to populist and interventionist policy. Exposure to commodities and hence to China has hurt LatAm, although further weakness in China may counter intuitively cause China to resume infrastructure investment thus reviving or supporting commodity markets to the benefit of LatAm. For the moment, however, growth continues to slow with worrying steadfastness across LatAm, with the exception of Mexico, where manufacturing ties to the US and structural reform have helped. From the basket cases of Argentina and Venezuela to the better managed economies of Peru, Chile and Colombia, and some might include Brazil, growth is slowing rapidly and prices are rising alarmingly.

Policy and Rates

Post 2008, markets have been highly policy driven. Whereas two years ago central banks were aligned in accommodative mode, today we find the US Fed and the Bank of England leaning towards tightening and everybody else from the ECB to the BoJ and the PBOC leaning heavily in the other direction, threatening if not already operating some form of QE or other expansionary policy.

The quality of economic growth in the US is sufficiently unclear that the Fed’s policy will be highly uncertain. Market expectations for the timing of the first rate hike has moved back and forth over 2015 and even early 2016. Speculation about the timing of the eventual rate hike is unproductive. Instead, an analysis of the motivation and constraints on the Fed yield more information and trading signals. Apart from growth and inflation, the Fed will also focus on financial stability and the debt service costs of the US treasury. We expect therefore that the USD term structure is more likely to flatten from here across 2s and 10s and 2s and 30s. Not only is this supported by the relative undersupply of fixed coupons but the technical picture is supportive as are inflation expectations in the US. Given the recent introduction of Treasury 2 year Floating Rate Notes, the willingness of the US Fed to raise rates may be moderated. With the short end at low risk of rising, the long end is still an attractive position to take.

Spread between 30 and 2 year US treasuries. Ample room to flatten.

The ECB is in a different position with deflation risk and recession facing even the region’s engine of growth Germany. France is in more a precarious position. Fortunately, Mediterranean Europe is sufficiently distressed that recovery is the more probable scenario. In addition to new LTROs the ECB has embarked on asset purchases of asset backed securities which may crowd out private participation in the European ABS market. Buying of sovereign bonds is a last resort that has not yet been activated. The ECB is far away from raising short rates. Like any central bank, its control over the long end of the curve is tenuous. That said, inflation expectations, or more precisely deflation expectations are likely to flatten term structures in EUR across Bunds and OATs.

The steady deceleration in growth in China and the withdrawal of the US Fed from large scale asset purchases is likely to encourage the PBOC to ease monetary policy both on a wholesale as well as macro-prudentialbasis. The macro-prudential efforts are already underway but have been criticized for distorting market prices and thus allocative efficiency. The PBOC has most recently cut interest rates as well as liberalized deposit rates. With the visibility towards slower growth, the PBOC can be expected to be more aggressive in its policy. While cutting rates may lower borrowing costs in theory, liquidity provision and an expansionary balance sheet policy are likely to have more impact on effective borrowing costs and we expect more action through the RRR, the PSL, the MLF et al. This, coupled by central government encouragement to local governments to expedite infrastructure investment will likely be deployed to support the decelerating economy.

The Reserve Bank of Australia is in neutral to accommodative mode as weak commodity prices impact the Australian economy. Inflation has been slowing and the possibility of a rate cut in 2015 is rising. One area of the Australian bond market stand out: CGS treasuries where the outperformance of hard duration has buoyed AAA sovereigns. The inflation and rate outlook for Australia imply a continuation of the trend in AUD duration. The Australian RMBS market which has performed remarkably well is now fairly priced to expensive as new production trades at 2007 tights.

Generally for the Emerging Markets, the economics of the USD investor need to be considered, since the USD investor is a significant investor and a marginal market mover. The main consideration in a regime of a strong USD is the net yield for holding a local currency bond when hedged back to USD. On this basis, the terms structures of Brazil of Indonesia, for example, are insufficiently steep to attract the USD investor. A strong USD is therefore a threat to Emerging Market bonds of longer maturities.

Credit:

While we are optimistic about US economic growth and corporate profitability, the pricing of corporate credit in the US is generally not attractive. An ordering of US corporate capital structure would see a preference for equity, followed by senior bank loan, then senior unsecured claims. Equity is trading between fairly valued to cheap relative to bonds while bank loans have the added benefit of a floating rate coupon as wel
l as structural seniority and collateral. The uncertainty in the US high yield market was underlined in October 2013 as markets sold off. The size of the drawdown was remarkable given the health of the underlying borrowers' businesses. Valuation, pricing, was clearly the issue; bond prices were trading well in premium territory. While the high yield market has since rebounded, pricing remains rich and the market fragile. Historically, high yield is now trading tight relative to investment grade, where arguably there is better value to be found.

High Yield trades tight to Investment Grade. Room to widen.

In the US market, perhaps the most interesting market remains the residential mortgage backed securities market, particularly the non agency or private label market where, despite a 5 year bull market, relative inexpensive paper can be found. Non agency RMBS is sensitive to the domestic economy of the US as well as the value of the underlying collateral, residential real estate. The pace of recovery in the Case Shiller Index has slowed but remains firmly in positive territory and is expected to grow at circa 5% going forward. Cumulative default rates and delinquencies continue to improve albeit at a slower pace. The opportunity in agency RMBS is more complex and involves extracting the cheapness of the mortgage derivatives, namely principal only and interest only securities which trade cheap to the underlying mortgage pools. This opportunity can be exploited via specialist ABS hedge funds. Apart from this arbitrage trade, a long position in agency paper will benefit from our benign outlook for rates and our expectation for low inflation and curve flattening. We also expect the mortgage basis to remain tight on demand and supply as the Fed continues to replace paydowns.

The next most important corporate credit market is Europe. European corporate bonds have several advantages on their US counterparts. Issuers in Europe remain in deleveraging mode compared with the US which is well into releveraging mode. European bonds often carry maintenance as well as incursion covenants making their indentures more loan-like than the covenant lite issues across the Atlantic. The environment for European credit is also positive from a liquidity perspective. The ECB’s first excursion into QE involves the TLTRO as well as direct asset purchases. This year’s LTROs have seen lukewarm acceptance while outright asset purchases are only just beginning. The LTROs of 2011 saw robust take up as they caught the market by surprise and allowed private commercial banks to disentangle their cross-national holdings. The current LTROs are conditional and require the participating banks to extend credit to private enterprise, an exercise that requires a full scale recapitalization of the Eurozone banking system to animate. This is underway. More significant is the ECB’s program of direct asset purchases at first covering ABS and covered bonds. The impact is likely to be modest unless the ECB can de facto underwrite new production. If Europe slows towards recession and deflation, it is possible that the ECB may have to establish a program of buying ABS on a TBA basis. Buying legacy loans will have moderate impact on the real economy even if it does strengthen bank balance sheets. The insufficiency of policy in the Eurozone will force the ECB into protracted incrementalism which is likely to support credit markets across the spectrum of ratings and seniority. Bank capital is one area of continued opportunity as bank recapitalizations tighten spreads for perpetuals and CoCos. The interventionist tone of the ECB will likely reinforce the macro theme of convergence of country risk as the ECB reunifies the region. The recent dispersion in credit spreads across Europe in the last 6 months is likely to reverse in 2015.

Asian credits outperformed Europe and US credits confounding consensus views at the end of 2013, views influenced by the high volatility triggered by the US Fed’s stated intentions to withdraw from net large scale asset purchases. While Asian High Yield and Crossovers represent a decent spread pickup to developed market corporate high yield, the strong USD and rising USD rates pose a risk. USD based investors will look to finance their bond positions in local currency and current term structures are not steep enough for the economics to work. Investment grade has outperformed this year spreads are at 5 year tights. That said, Asia investment grade continues to trade sufficiently wide of US investment grade, some 40 basis points, to make Asian IG quite attractive. Asian HY versus IG spreads have widened from summer tights (272 bps) but the trend may likely continue as defaults and recoveries in the more stressed areas such as China’s property sector drive HY spreads wider. We still prefer Investment Grade and Crossover credits over the riskier end of High Yield.

Equities

The US economy is visibly strong and company earnings are robust. In fact, one of the reasons for the dissatisfaction with the economy is that the fruits of the recovery are increasingly accruing to corporate rather than household America. Artificially suppressed interest rates across the term structure have allowed companies to raise record amounts of debt to finance not so much investment and capital expenditure but rather dividends payouts, share buybacks and M&A. Dividend payouts appeal to yield addicted investors, particularly those investing via mutual funds, share buybacks create direct demand for equities while reducing the stock of equities outstanding and M&A this year has remarkably seen both target and acquirer shares being rewarded at the same time. The result of all this is that equities are no longer cheap but rather are fairly valued when compared against US treasury and investment grade credit yields. Bearing in mind that markets are wont to overshoot and tend to reverse only at extrema, US equities remain an attractive investment. As long as the US treasury market behaves and interest rates are not raised too aggressively.

S&P yield less US 10 Yr yield. Not cheap but not expensive either.

S&P yield less US corporate Baa yield. A toss up.

European equities have done reasonably well in local currency but value lies in corporate debt. With the introduction of the ERM in the nineties and later the Euro, European equities converged and traded as industry blocs as opposed to country blocs. This theme allowed relative value traders to generate alpha by trading sector variability. In 2008 the convergence was most acute, but by 2011, the Eurozone crisis had led to a divergence of country risk and localized funding costs. This resulted in equities trading along national lines once more. Traders who recognized this could trade equities and generate alpha on a macro country risk premium basis. With the ECB’s “whatever it takes” approach to containing sovereign risk, a new era of convergence is upon Europe and companies will revert to trading as industry sector blocs once more. There is therefore alpha available for extraction in the Eurozone. At the same time, the sub optimal currency regime fails to clear various product and factor markets, creating further inefficiency and trading opportunity. At a less granular level, the relative valuation between equities and bonds, the seniority of debt and the strength of European bond covenants favour high yield as the trade expression for European companies.

SXXP earnings yield less CS HY yields: Not much to separate them but equities are riskier.

A number of things recommend China domestic equities as a high conviction trade. Firstly, in a world where the main concern in equity markets is valuation, China equities are cheap. Forward price earnings ratios are 15.8X for the S&P500, 19.6X for Nasdaq, 13.3X for the Eurostoxx and the FTSE, 17.0X for the Nikkei, the Shanghai Composite’s 9.5X, the Hang Seng’s 10.3X and the Hang Seng H share Index’s 6.9X look attractive. Secondly, what has constrained China equities has been tight monetary policy at the PBOC. Arguably, the PBOC had been operating too tight a policy due to its mis-expectation that global QE would introduce inflation to China via the tradable goods sector. With inflation at current levels, the PBOC has begun to loosen policy and is expected to maintain a loose policy for the foreseeable future. Thirdly, and most importantly for the long term prospects of the Chinese economy, the Party announced at its Fourth Plenum that it is embracing a rule by law and has elevated the constitution to the core of the socialist legal system, including establishing circuit courts beyond the influence of local government, among other things. While some see this as window dressing, the complexity of governing a diverse people with growing wealth and expectations in a world of open communications and information flow is forcing the Party to decentralize and to decentralize in a stable fashion, which requires rule not only by law but of law. The long term impact will be felt directly through better corporate governance and improving ROEs.

Latin America is a troubling area. Apart from Mexico the rest of Latin America appears to be in or nearing stagflation. While equity markets in Argentina and Brazil have done well in local currency terms, exchange rate volatility and depreciation have all but nullified USD quanto returns. The problems in LatAm are tied to an over-reliance on China demand for commodities and further weakness in China may spur a return to infrastructure investment which could give a fillip to the region. This is a low probability prospect, however, and best undertaken if the catalyst is seen and some momentum has built up. Shorting is not advisable on account of expensive borrow, and the tail risk of the aforementioned China infrastructure build. The region's equity markets are best underweighted or avoided for now.

Risks and Longer Horizons

The main exogenous risk to the world financial system is geopolitical in nature. And yet, the catalysts are often if not always economic. People get used to certain standard of living and a slowdown in long term economic growth rates encourages more competitive and less cooperative behaviour. This can manifest in more economic and martial conflict. Inequality of wealth and income has increased significantly and may reach a point at which the less well endowed consider their chances of advancing to the more well endowed stratum improbably low, a point at which they tend to seek social and political change.

At a more visible time frame, central banks have been printing money aggressively since 2008 (although the US Fed has recently stopped), with less than stellar results in the real economy. It is not clear when the world's large economies will be able to stand on their own without extraordinary fiscal and monetary support and indeed how central bank balance sheets will be restored to a more manageable size. The ECB and the PBOC are only just getting started while the BoJ seems hostage to providing ever increasing doses of monetary analgesic. Currently the benefits of QE have fallen disproportionately on financial assets while the real economy has recovered at a disappointing pace. Part of this is due to the distribution of wealth and the differential marginal propensities to consume by wealth bracket.

Equity valuations in the developed markets are no longer cheap. Even in Europe, the market has been selective and quality is now expensive. Asia is the only region showing any sign of value. For equities to advance sustainably earnings have to grow sustainably which requires robust and stable economic growth without the aid of artificial stimulants. Equities have in recent years rerated on the back of limited supply, and steady demand, some of which from the issuers themselves in the form of bond financed equity buybacks. There are limits to buybacks and M&A before valuations become unreasonably high and free floats test the limits of credibility.

Global concerns over inflation are not useful as they focus on an instrument variable and not the root cause of slow economic growth. The Japanese deflationary experience still worries policy makers just as the Weimar hyperinflationary experience still haunts (particularly the Europeans) by turns. By inflating central bank balance sheets to this degree the world's central banks have placed themselves in a position where they have worry about both deflation, the by-product of deficient demand, and inflation, a risk should confidence fail. The establishment of repo and reverse repo facilities by the Fed and the various central banks is evidence of their concern on both sides of price stability.

While on the surface the world is a benign place and the investment landscape presents petty, albeit complex, problems, fundamental issues have not been adequately addressed. The reforms witnessed in India and Indonesia and Japan are encouraging but inequality of wealth and income, the lack of ideology as a backbone for both corporate and national policy are but some of the shortcomings which remain outstanding. Political and economic will for reform remain constrained by governments' foreseeable terms in office. Looking at the pricing of risk in the various markets, the probability of major dislocation remains low for the next 6 months to a year, and the usual short volatility long tail risk strategies should perform. Beyond that, especially if market volatilities continue to compress storing up risk for the future, the outlook may be more fraught. For now, investment strategy is a game of chicken.

VIX: How low can you go? When will the market blink?

MOVE Index (US treasury volatility): The Fed’s got your back but for how long?