Global Growth Model

Stratton Street's disciplined investment process incorporates both top down and bottom up elements when constructing our portfolios. We understand the importance of macro positioning across a market cycle to ensure consistent performance. Whilst our credit selection process ultimately determines the underlying positions within the portfolio, we utilise a number of proprietary models to ensure we are well positioned from both a duration and credit risk perspective. Macro positioning is an essential for effective management of credit portfolios - and we are active in rotating our macro positioning to fit.

One of our primary models that we have been using since 1997 is the Stratton Street **Global Growth Model ("GGM") -** this is a proprietary model that utilises three economic indicators:

- *US ISM*[1]
- *German IFO*[2]
- *Japanese inventory to shipments ratio*

The data points above are widely available and we use simple regression analysis to determine the weighting to each factor. More importantly, the factors incorporated within our GGM are typically available ahead of OECD Industrial Production ("IP")[3] data by ~6 months, providing us with a leading indicator of where we are in a global macro cycle.

This information can be invaluable to credit managers - by understanding where we are within a global macro cycle we can determine how much credit risk we want to take. For example we know that weak global growth is supportive of high grade bond markets; whilst in an expansionary phase lower grade credits outperform.

Real world examples

2007/08 is a great example of how useful leading macroeconomic indicators can be when it comes to positioning. The period 2003-2007 can be characterised as an expansionary environment with ample liquidity and strong credit growth - most risk asset classes performed well during this period.

The onset of one of the longest recessions in history, driven by the 'Global Financial Crisis' ("GFC"), began with the sub-prime mortgage crisis in the US and spread across the globe. Global growth collapsed as liquidity and credit dried up. Our GGM was already indicating a sharp downturn across financial markets and we therefore positioned our portfolios accordingly (see point [i] in chart 1 below). As stated above we know that during periods of weak global growth, higher grade credits (UST's / AAA / AA) outperform, and as such we positioned our portfolios in a very defensive manner - 65% of portfolio was in UST / AAA credits, with no exposure to BBB or lower grade credits (chart 2).

Thanks to Central Banks across the world (post Lehman collapse in 2008), we saw a 'V-shaped' recovery in global growth as credit flooded the market in the form of QE (see point [ii] in chart 1). Given OECD has a time-lag on our GGM, we were able to begin to rotate our portfolios into lower grade (N/B still investment grade) credits to take advantage of undervalued opportunities on wider spreads (chart 2).

We continued this process until our model had identified the peak of global growth cycle around mid-2010 (see point [iii] in chart 1). At this point in time we had rotated our portfolios completely away from UST/AAA into lower grade A/BBB credits - the average yield on the portfolio was in excess of 10%!

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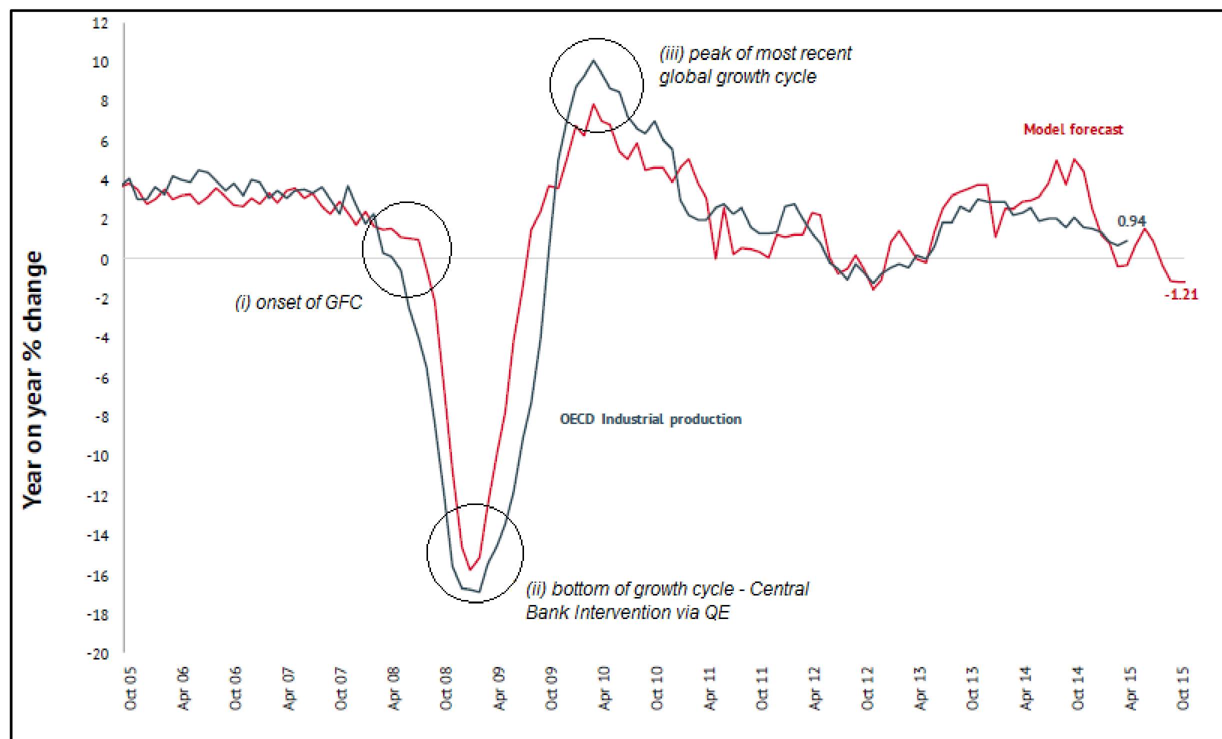
[1] *An index based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.*

[2] *The Ifo Business Climate Index is a closely followed leading indicator for economic activity in Germany prepared by the Ifo Institute for Economic Research in Munich.*

[3] *OECD Industrial Production ("IP") in our view is a good proxy for global growth*

Stratton Street – Global Growth Model

1. **Stratton Street Global Growth Model**



Source: Bloomberg and Stratton Street Capital LLP

2. Stratton Street Global Portfolio Credit Positioning

Renminbi Bond Composite	AAA	AA	A	Baa	Ba	B	Cash	
July 2008	65%	13%	20%				3%	(prior to Lehman collapse)
March 2009		28%	42%	18%			12%	(post Lehman)
May 2010		25%	38%	30%	2%	3%	2%	
March 2017	12%	41%	31%	15%			1%	

Global Core Composite	AAA	AA	A	Baa	Ba	B	Cash
May 2010		9%	29%	44%	3%	7%	8%
December 2010		10%	29%	40%	11%		
March 2017	3%	30%	40%	25%			2%

It is important to note that we employ a number of economic models when thinking about how to position our portfolios - not just our GGM. For details on our latest Global Growth Model please contact us.

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