Conference Call Transcript – Why the bond bull market is not over

Andy Seaman, CIO and Partner (AS) & Ben Day, Head of Sales (BD)

BD (Opening comments/strong 2017 performance): Stratton Street Capital (SSC) have a long history of managing money in the bond space, having conviction in their positioning and relying on experience/fundamental process to navigate different environment. The 2013 Taper Tantrum and subsequent years being a good example. We recognise that we are in a different environment today - now it's time for Andy Seaman to explain why as a firm we believe the best place to be positioned is at the long-end in high grade bonds.

AS: Hello everyone – today we are focusing on our outlook for bond markets. Most people when talking about bonds and rates are referring to US Treasuries; we are credit managers and we will come onto the differences in terms of performance between UST and credit later on but we will begin with Treasuries first then move onto the implications for credit.

AS: It is quite clear the world economy is growing strongly (both the US and globally); it can be somewhat of an odd concept that long-dated bonds would perform well in this environment but as a manager with multi-decades of experience we are familiar with this sort of environment. 'Typically' long end performs well and short end gets hurt.

AS: SSC's expectation is that the *Fed will tighten 2 to 3 times this year*. We also forecast a relatively flat curve out to 30 years at around 2 ¼ %. There is a possibility that if inflation does pick up in the short run, then we expect further Fed tightening and we would in turn expect longer dated yields to flatten (more on this later).

AS: (slide 3) – Global Growth is strong – the OECD Industrial Production projections for 3-6 months is around 5% which is the strongest it's been for 10 years and strong relative to history. *This is positive for credit in the short term (hence we have credit beta/duration in the portfolio at present)* however we are sceptical of the longer term growth prospects based on demographics.. First we need to cover off the next 12-18 months scenario.

AS: (slide 4) – The *Chicago Fed National Activity Index* has been a reliable predictor of recessions in the past (predicted 2008 recession 12 months in advance). Currently the numbers do not show any signs of a recession yet; however *80% of the last 15 rate tightening cycles have been followed by a US recession*. So the odds are stacked in favour of a recession – we feel we are currently traveling along a road and there is a recession over the horizon but we are not there yet; however in this scenario you do want to be in high grade bonds.

AS: (slide 5) – *Our Fed funds model*, has done a good job in predicting QE (and the subsequent removal). Clearly rates are on an upward trajectory. This also helps to identify when excessive monetary accommodation might be necessary.

Fed Fund model includes: capacity utilisation, unemployment rate and inflation. We built the model in 2002 after Fed Governor McTeer made an interesting comment in response to journalists when asked about potential rate changes. His response caught our attention at the time because he said something along the lines of, "when capacity utilisation reaches x and the unemployment rate reaches y, come and talk to me about rate changes'. What stunned us at the time was how well the model fitted the historical data. Even more fascinating are the periods running up to the 04 tightening cycle and the models prediction of QE. We used the model to predict that fed rate increases would be greater than the market assumed at the time (2004)

AS: (Slide 6) – We like regression based models, however we don't use them as a black box but instead to inform and help shape our view. Clearly with oil prices off their lows, that helps push up inflation in the short run. We emphasise our belief it's a short run phenomenon.

AS: (Slides 7/8/9) – Looking at 5yr UST, our model suggests the short end is the wrong place to be in a rate tightening cycle. 10yr has performed better but the best performing assets are at the long end. This is purely driven by the fact that the short end of the curve is influenced by rate changes whilst the long end is influenced by longer term inflation expectations. Provided the Fed is ahead of the curve and tighten into that environment then the long-end will do well. If the Fed did get behind the curve you would expect to get a steepening; but we maintain our belief they are ahead of the curve at this stage of the cycle.

AS: (Slide 10) – This slide shows during last three rate tightening cycles, the one place you have always lost money is at the short end. 94/95: on a duration adjusted basis you wanted to be at the long end. 99/00: the long end was stable but again you lost money at the short end. The period most akin to today's environment is the 04-06 period where you can see you lost money at the short end, but the long end you actually made money.

If you look at the Taper Tantrum, since that time the short end of the UST yield curve has lost you money and the only place where you have made money is the 30yr.

Coming back to what drives the long end, it really comes down to future expectation of global growth and inflation. Slide 11 shows our global growth model again which actually shows the growth is relatively strong. On the next slide (12) we've drawn in where we think the long term trend is headed and it is our belief that it is going to be lower for longer, based on demographics

AS: (Slide 13) – This slide shows the various stages of expansion in the US since the 1980's. Part of this chart highlights how long the current cycle is relative to history, but looking at the mid-late 80's, the average growth rate was around 4.3%; during the next cycle it drops to 3.6%; in the next phase in early 2000's it drops again to 2.7% and finally the latest expansion phase, average growth has been only 1.8%.

We believe this slow and steady decline in the growth rate is because population growth rate is slowing, which in turns drives growth – as we have a good idea about the rate of population growth into the future we can make predictions which are normally reasonably accurate as we know how many people are alive in the world today and how many children are being born. In the developed world the replacement rate is far too low, so net-net you are seeing are shrinkage in the working age population.

AS: (Slide 14) – this shows median ages of a select group of countries at 2015 and 2050 (using UN data). All countries age; most people know that Japan is an ageing country but Korea is expected to take over Japan by 2050 as the world's 'oldest' country based on median age. With ageing populations around the world we also see a change to investor behaviour – as people age they look for 'safer' investments and they need income. When you look at the projections of holdings for investors out to 2050 you will see an increase in the holdings of bonds, as they age they need fixed income as investments.

AS: (Slide 15) – This shows where we see the biggest risks (in Europe). This chart highlights the changes in working age population (without any migration). Now Germany as an example, is expected to have a large increase of migrants into the country.

This charts shows that a large number of countries within Europe will see they working age population decline by more than 30% by 2050 – those countries with red bars are also heavily indebted. When thinking about the implications for these countries, how are they going to finance the debt levels, that we measure in excess of 100% of GDP, when their working age populations are shrinking?

When looking at migration trends in the recent past, the population from the indebted countries has also been shrinking in the sense that workers are leaving to find better opportunities elsewhere making a bad situation much worse. Germany is a major beneficiary of the recent migration trends and will only see it's working age population fall by ~16% with migration; this is still a significant decline.

Thinking about long-term implications of this decline, what happens to property prices if you see a shrinking population? Today you have demand for property, but as populations fall the relative supply will be in excess of demand. Looking at other examples you saw property prices in Japan crash and also if you look at individual cities in the US which have seen big population declines, it's usually associated with falling property prices. Thinking about the implications for manufacturing, if demand is falling one of two things can happen; either you lower prices or cut back production. Simply speaking this is why we at Stratton Street see weaker growth and weaker inflation going forward. The reason we have had a 30yr+ bull market is due to the fact we have seen declining growth rates due to falling population growth rates and that trend is set in stone for many decades to come.

AS: (Slide 16) – the outlook isn't all bad as there are countries like the Philippines that will see improvements in the working age population – this does also bring its own challenges with it but if you are growing fast you are in a much better position to take on debt if you need to because growth rates help offset that over time. You need to be selective about who you want to lend to over time and demographics and indebtedness plays a large role in figuring out which countries you want to avoid. There isn't a clear split between which countries will do well and which will do badly when looking at EM/DM, it's really more a story about the difference between creditors and debtors.

AS: (Slide 17) – returning to the short run, this chart helps to highlight where *real yields* are in the US compared to the Eurozone. It's clear that the ECB are going to come under increasing pressure to raise rates over time given rates are so low and growth is strong. If yields rise in Europe, the periphery of Europe is going to come under increasing pressure. Another by-product of rising rates in Europe is the Euro is likely to strengthen – in that instance it will dampen down expectations as it will put downward pressure on inflation in Europe (and the same arguments apply to Japan as well).

It's not entirely clear what will happen but given the US has been actively talking down the USD recently it does seem to us that there will be upward pressure on the Euro and the Yen in which case it's quite possible that negative real yields remain. The way the gap possibly gets closed in the long term are *US rates declining further to come closer in line with European counterparts.* If we do see a scenario where European yields rise, the last place you want to be invested is in those highly indebted countries in the periphery of Europe as they will come under significant selling pressure. Either scenario tells you that it's not worth being in low-grade credits as they will come under pressure in both scenarios.

AS: (Slide 18) – one of the key themes to be thinking about is which currencies are likely to do well. We have been long standing advocates that the single most important driver of long term currency movements is *Net Foreign Assets* (NFA) and this chart shows you the linkage between NFA and currency movement's vs the USD since 2008.

The Swiss Franc and Chinese RMB are near the top – those creditor nations with strong NFA (along with Japanese Yen) will likely see their currencies appreciate over time. If the USD is weak there will be more inflationary pressures there so the Fed may have to tighten more (although they will likely view that as a temporary measure); but it all points to the same picture in our view: Higher rates in the US, not necessarily higher rates in Europe for the arguments mentioned above. If we do see higher rates in the US this is likely to be in the short run as the longer term fundamentals are not strong. *A flattening of the curve is the most likely outcome for the US and the rest of the world*.

AS: (Slides 19-21) – looking at where we see markets, investment grade bonds are generally at the tight end of the historical range and so is high yield. When looking at EM, relatively it looks more attractive and there are individual credits that offer tremendous value. Whilst EM has been hurt over the last few years there are pockets of opportunities in this space which we will talk through.

AS: (Slides 22-25) – we utilise our proprietary global credit pricing model to identify mispriced credits and work out the fair value of curves. You can see on slide 23, the bonds that are in our portfolio are trading significantly away from fair value. IPIC (INTPET 41) you can see is trading around 160bps over, which is ~100bps away from fair value (which should be south of 60bps). If that credit was to re-price to fair value we would see 13% of capital gain (given 13 year duration) or we get an additional 1% in yield. That additional 1% is significant and should make a difference when deciding where you should be positioned on the credit curve. If you have long dated high grade bonds on very wide spreads (i.e. 100bps cheap) and your expectation is that UST's will widen by 30bps (this is *not* our base case scenario) then the credits you own are still 70bps cheap which is significant. When it comes to credit, the duration decision is different from the duration decision of holding UST's. Slide 24 shows some A rated credits we like (MEX 40's as an example) which fall under the EM space. On Slide 25 you have names such as PEMEX which has performed well but still offers significant value. Southern Copper (SCCO) is a credit we've held which has performed exceptionally well and we have recently liquidated this position; it's returned ~14% over the last 12 months and at the same time a similar duration UST would has returned -0.4% over that period.

You can have an environment of UST move sideways or even rising but credit can still perform well – the trick is identifying those credits that are significantly undervalued in the first place and we have the tools to do that.

Summary:

- Multi-decades of experience tells us long dated bonds should perform well in this current environment.
- SSC expect the fed to tighten 2 to 3 times in 2018 and forecast a over the horizon.

- Our models show in the past, the short end of the curve is the wrong place to be during a rate tightening cycle - you lost money at the short end during the last three rate tightening cycles.

- What drives the long end is future expectations of global growth. There has been a slow and steady decline of the growth rate since the 1980's.

- We believe the decline in the growth rate is due to a slowing of population growth. The replacement rate in the developed world is too low and causing a shrinkage in the working age population.

- Many countries in Europe will see their working age population decline by more than 30% by 2050.

- The population decline will lead to excess housing supply and in turn, falling property prices. Lower demand in general will lead to lower prices or cut back production in manufacturing.

- The 30 year bull market has been in place due to declining growth rates due to falling population growth rates which is set in stone for many years to come.

- SSC believe the single most important drive of long term currency movement is Net Foreign Assets. Creditor nations with strong NFA are likely to see their currencies appreciate.

- A weak USD means more inflationary pressures and the Fed may tighten more. Higher rates in the US will only be short term.

- We use a global credit pricing model to identify mispriced credits. We currently see pockets of opportunity in the EM space.

- For credits, the duration decision is different to the decision of holding USTs. If you have a long dated bond with a very wide spread (100bps cheap) and you expect UST's to widen by 30bps, the credit you own is still 70bpts cheap.

- Even if UST move sideways or rise, by identifying undervalued credits, fixed income can still perform well.

Questions:

Q1: *Pockets of growth in the world and picking up (US for example) – with things such as US corporate tax cuts coming through will that continue pushing equities / credit higher as per last year and equally if we see further oil price rises / China pick up could that be seen as a tailwind at all?*

AS: You need to make a distinction between short run and long run. Take the US as an example – the output gap is virtually closed and the potential to grow strongly is much diminished as the economy doesn't have a lot of spare resources. It gets increasingly difficult to grow at a fast pace and at the same time every piece of strong growth will be met with a Fed rate hike; they are mandated to control inflation and if they see growth pressures that are too strong they will continue to tighten. They will keep tightening until such time as they cause growth to start slowing, which is partly the reason you tend to get a recession in the end as you can't grow above potential for too long.

It doesn't matter how strong growth is, what matters is what the Central Bank's response is – where we would get nervous is if we don't think CB are responding quickly enough.

Q2: *Do we have a return expectation for next three to five years annualised?*

AS: If we are talking about the Renminbi, take whatever I am going to say and add 4% a year. Our expectation in the long run is the Renminbi is going to appreciate around 4% per year. We made that forecast a few months ago and in the short run we believe the Renminbi is likely to be stronger than that.

If you look at our global strategies, we start with the underlying yield which is roughly 4% on a single A portfolio in investment grade bonds with an average issue size of $1.6bn – just a reminder these are liquid bonds. Can we make 3.5% from capital gains? I mentioned a few bonds earlier which are mispriced by 100 or 200bps which translates to roughly 10% and 20% capital gains if you ignore the income. So I would say that 7.5% is our normal environment and if there is a US recession around the corner, high grade bonds could perform much better than that. If you ask me about returns for high yield, in the environment we see of a recession during this cycle, then high yield could get badly hurt. It really depends how fast the Fed have to tighten but we need to think not where we are today but where we are headed.

Contact

Contact details:	Ben Day, CAIA - Head of Sales
Email:	Benday@strattonstreet.com or Sales@strattonstreet.com
Address:	Stratton Street Capital LLP, 200 Aldersgate Street, London, EC1A 4HD
Telephone:	+44 (0)20 7766 0806 or +44 (0)20 7766 0800
Website:	www.strattonstreet.com