Stratton Street

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

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- 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 environments.
- Believe we are best positioned at *the long end in high grade bonds*.
- With multi-decades of experience we are familiar with this environment and typically the long end performs well and the short end gets hurt, contrary to general opinion.
- We expect the fed will tighten 2-3 times this year and forecast relatively flat curve out to 30 years at around 2 ¼ %.
- Global growth projections are strong at around 5% pa for industrial production over the next 3-6 months (based on our Global Growth projections).
- Positive in short term for credit but we are sceptical of longer term growth prospects due to demographics.
- Chicago Fed National Activity Index has been a reliable indicator of recessions. The numbers aren't suggesting a recession yet, however in 80% of the last 15 rate tightening cycles it has been followed by a US recession.
- Looking at our US Treasury models, we can demonstrate that the best performing assets are at the long end during a rate tightening cycle. This is driven by the fact that the short end of the curve is influenced by interest rate changes whilst the long end is influenced by longer term inflation expectation.
- Provided the *Fed remains ahead of the curve* and tighten into that environment then the long-end will do well.
- Looking at the mid-late 80's, the average growth rate was around 4.3%; during the next cycle it dropped to 3.6%; in the next phase in early 2000's it dropped 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 due to population growth rate slowing*. Based on how many people are alive today and how many children are being born, we know in the developed world, the replacement rate is too low so net-net you are seeing a working age population shrinkage.
- With global aging populations, we expect investor behaviour to change, particularly focussing on safer, income generating investments.

- A large number of countries within Europe will see their working age population decline by more than 30% by 2050.
- Countries such as Spain and Portugal are heavily indebted – how are they going to finance the debt levels that measure in excess of 100% of GDP when their working age populations are shrinking?
- Migration trends show the population in indebted countries has been shrinking owing to demographics but also due to workers leaving to find better opportunities elsewhere making a bad situation 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.
- The long term implication of this decline are reduced demand for property relative to supply. For examples, we saw individual cities in the US which have seen big population declines having falling property prices.
- There are also implications for manufacturing where if demand is falling we see either lower prices or a cut back in production. This is why Stratton Street believe there will be weaker growth and 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.
- It's not all bad, with countries like the Philippines due to see increases in working age populations. Therefore we need to be selective about who we lend to over time.
- Demographics and indebtedness plays a large role in figuring out which countries you want to avoid.
- In the short run, it's clear 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, then the periphery of Europe is going to come under increasing pressure. The Euro is also likely to strengthen due to rate rises which will dampen down expectations due to downward pressure on inflation in Europe.
- US has been actively talking down the USD recently so it seems to us there will be upward pressure on the Euro and Yen in which case negative real yields may remain.
- The way to possibly close the gap in the long term is US rates declining further to come closer in line with its European counterparts.
- If we do see are scenario that European yields do 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 do not want to be in low-grade credits as they will come under pressure in both scenarios.
- A key theme to think about is which currencies are likely to do well. We believe the most important driver of long term currency movements is net foreign assets (NFA).
- Creditor nations with strong NFA will likely see their currencies appreciate over time. If the USD is weak there will be more inflation pressures so the Fed may have to tighten more.

- This points to the same picture in our view: Higher rates in the US. This is likely to be in the short run as the longer term fundamental are not strong.
- A flattening of the curve is the most likely outcome for the US and the rest of the world.
- Where we currently see the market, Investment grade bonds are generally at the tight end of the historical range as well as high yield.
- EM looked relatively more attractive are some individual credits offer tremendous value.
- We utilise our proprietary global credit pricing model to identify mispriced credit and work out their fair value.
- One example is IPIC credit which is trading around 160bps over, which is around 100bps away from fair value of 60bps.
- If this credit was repriced, we would see 13% capital gain or we get an additional 1% in yield if yields do not compress.
- The additional 1% is significant and should make a difference when deciding where you should be positioned on the credit curve.
- With long dated high grade bonds on very wide spreads (i.e. 100bps cheap) and lets assume 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 very different from the duration decision of holding UST's.

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