BlueBay
Asset Management

Evolution and reversals – catalysts for alternative strategies

The peaks of the early 80s gave way to a compression trend for US Treasury yields that has lasted until very recently. This span of almost four decades – which covers the whole career of most active investment professionals – has featured notable events in the economy such as the launch of the euro; emerging market and global financial crises; unprecedented levels of quantitative easing and a prominent shift in banks and their role within the financial system. The turn in Treasury yields, as quantitative easing gives way to quantitative tightening, has broader implications in a more complex investment environment, which is the combined result of the preceding layers of changes.

Alternative strategies, accompanied by a more nimble approach and a focus on critical thinking, are emerging as a potential solution for investors looking for alpha in an environment that no longer enjoys the tailwind of compressing risk-free rates.

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Alternatives to core fixed income

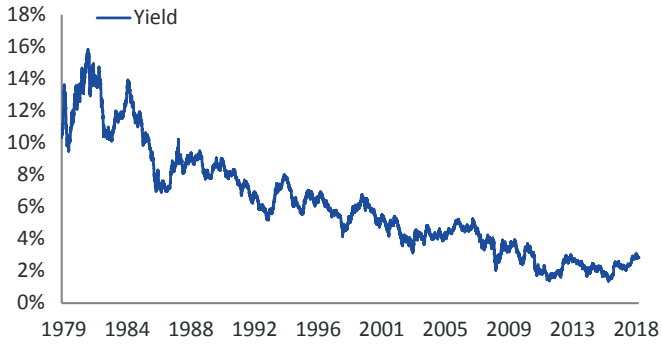
June 1984 proved a marker for two significant events. In the world of entertainment, moviegoers were treated to a triple whammy of future cult classics with the release of ***Ghostbusters, Gremlins*** and the infamous spoof movie ***Top Secret!*** The investment community marked its own milestone as 10-Year US Treasury yields reached a peak of 13.95% – what was to become the last spike of the double-digit rates age following highs of 13.65% in February 1980 and 15.84% in September 1981.

Through subsequent decades, yields went into a compression trend, with only the occasional hiccup. This downward move was prolonged as the global financial crisis (GFC) – to which excessive laxity in credit contributed – triggered the administration of a broad market anaesthetic in the form of quantitative easing (QE) and open market purchase (OMP) programmes. Only with the removal of these accommodative policies is the cycle finally starting to turn.

Navigating the new environment calls for a different investment approach; a greater level of open-mindedness, dynamic positioning and the use of a toolset that empowers managers with the potential to exploit market movements and mispricings. This toolkit can take the form of alternative investment strategies, which we believe offer the most compelling way of capitalising on the return potential of more discriminating markets.

In this paper we discuss both the long term and more immediate environmental changes that have combined to bring an end to the multi-year rally in bond yields and success of the beta trade, leaving investors in need of alternative solutions for alpha generation.

FIG 1: 10-YEAR US TREASURY YIELDS 1979–2018

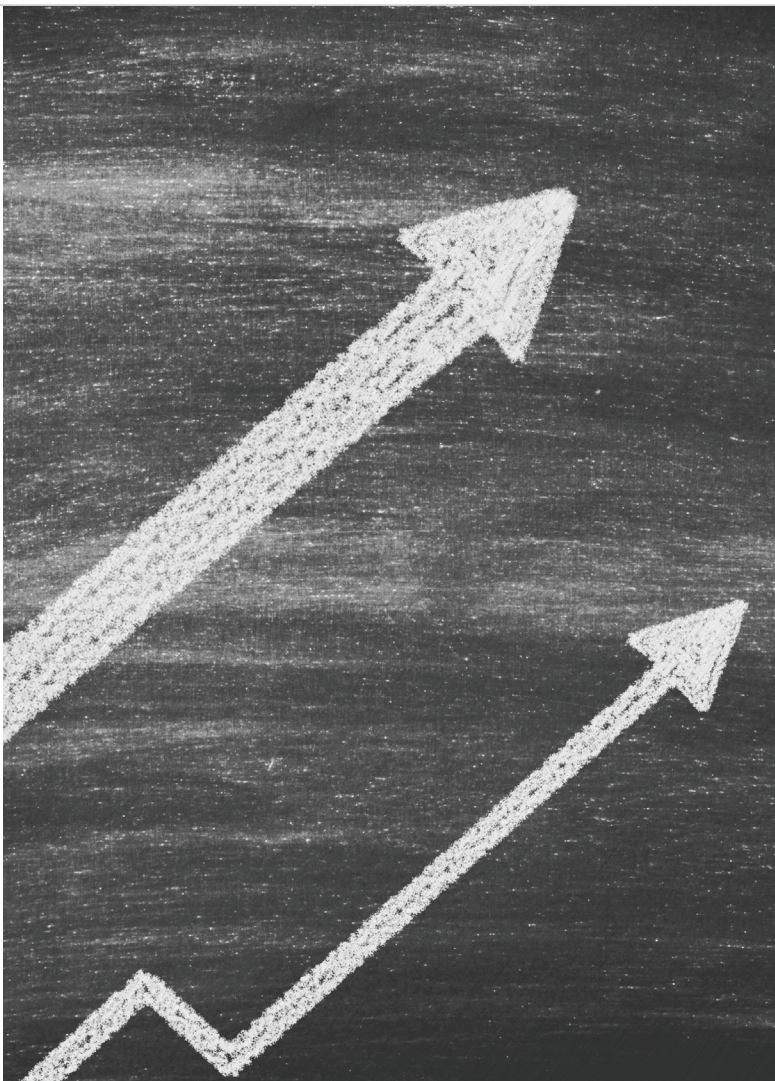


Source: Bloomberg, as at 29 June 2018

Implications of yield increases: Numerous and far-reaching

Today's investment landscape represents a paradigm shift in trading dynamics. In stark contrast to the yield compression trend we have grown used to, the normalisation is towards higher rates – an environment that impairs many long-only strategies that have proved successful throughout most managers' careers.

As yields normalise – and ultimately credit spreads too – dispersion starts to increase. As financing costs rise, asset prices begin to feel the bite of a tailwind becoming a headwind, and there is a bigger strain on company profitability due to the burden of higher-cost liquidity facilities and debt refinancing. This strain will test which business models pass the bar of elevated financing costs (maybe this leads us back to cult classics…), especially for more heavily levered companies, likely resulting in the repricing of securities with weaker balance sheets. We anticipate the outcome being a differentiated credit landscape and notable shift away from today's lack of dispersion.



Return of volatility

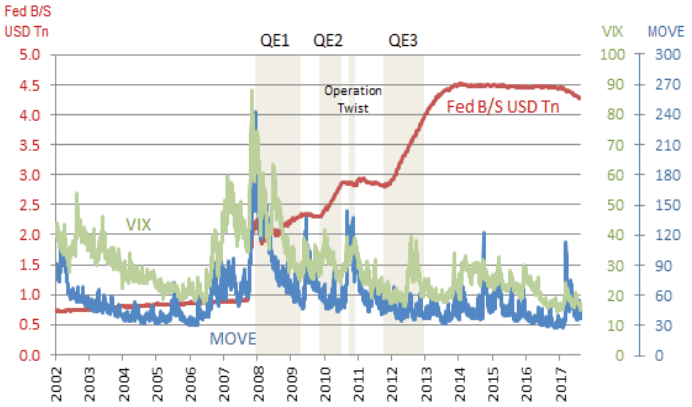
The other metric that was heavily suppressed during the QE years is volatility. Together with the lack of dispersion, lower volatility has constrained managers' ability to materially enhance performance per round of leverage.

These depressed volatility levels can be easily seen when looking at the S&P 500 volatility index (VIX) and the US Treasury volatility index (MOVE), which are both metrics of implied volatility. Looking at the data since 1990, 86% of the readings under the level of 10 for VIX and 90% of the readings under the level of 50 for MOVE have happened in 2017 and 2018 alone. If we split the series between 1990-2012 and 2013-2018, we can see that the average for the VIX has been 15 in the most recent period, as opposed to 20.5 in the previous cycle. In the case of MOVE, the recent average has been 68 versus 102. This makes rear-view portfolio management a perilous exercise, as risk metrics have been dampened by a monetary policy instrument that is no longer in place.

All this leaves us facing the following:

- Long duration strategies, favoured for decades, will likely not be such good structural positions going forward.
- Greater dispersion should bring more relative value opportunities.
- An ability to be nimble and tactical become even greater assets.

FIG 2: SUPPRESSION OF VOLATILITY DURING QE



Source: Bloomberg, as at 29 June 2018

The bigger picture

While the GFC and the subsequent QE efforts have been the most impactful events in recent times, there have been a number of other changes since the start of the century that have collectively reshaped global markets – resulting in an environment where alternative investments are, in our view, the most promising source of alpha generation within a diversified portfolio.

Looking at the **sovereign** landscape, its evolution is marked by a series of shifts.

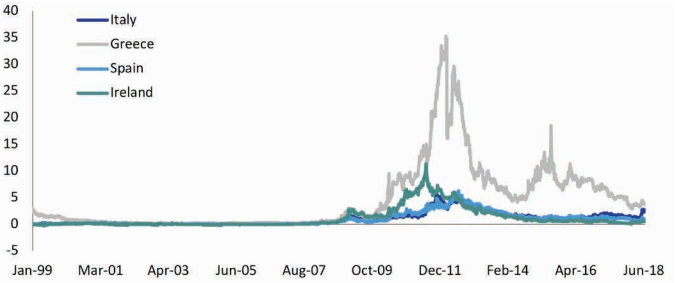
The **introduction of the euro** in January 1999 created the biggest change in the monetary system since the end of Bretton Woods in the 1970s. This led to a time where all sovereign credits in the eurozone started trading as interest rate products, where their valuations depended mostly on the time preference of money, expectations of interest rate policy, inflation and the interaction between the two – the 'reaction function' – rather than on the creditworthiness of the issuing government.

The GFC highlighted the extent of the disequilibrium that had been hidden by below fair value interest rates. Budgetary excesses and sub-optimal growth models were brought to light and public account deficits ballooned, putting strain on government finances. In reaction, markets placed exponentially higher risk premia on certain countries – primarily the Mediterranean and Ireland.

Whereas these premia have significantly compressed, this transition back to **treating certain eurozone issuers as credit concerns** rather than interest rate products, will prevail as long as high debt-to-GDP ratios remain – and we do not see any signs of material change in the near future.

The development of tools that enable managers to drive securities to price levels that better reflect the real risk involved is a positive step. However, there are merited concerns that, at times, short-selling could put unfair strain on the stability of sovereign debt markets. For that reason, safeguards were put in place in 2012 by the European Parliament in the form of **regulation on short selling** and certain aspects of credit default swaps.

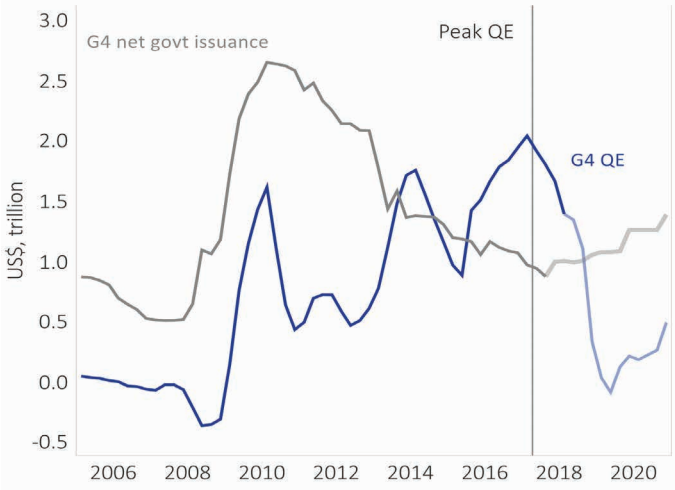
FIG 3: EUROZONE SOVEREIGN BOND SPREADS



Source: Macrobond, as at 29 June 2018

Developed market sovereigns currently hold **levels of debt-to-GDP that are, in my view, unprecedented** in a peacetime scenario. These have been accompanied by monetary policy developments in the form of QE programmes that have led markets and economies into uncharted territory. Strategies that are nimble and flexible should be able to adapt better to the upcoming phases of the scenario.

FIG 4: G4 NET DEBT ISSUANCE & CENTRAL BANK ASSET PURCHASES



Source: Macrobond; BlueBay calculations; latest monthly data for March 2018; note: annual flow of net borrowing by G4 – US, Eurozone, Japan and UK – governments and annual flow of G4 central bank asset purchases.

Following the Asian crisis of 1997 and Russian crisis of 1998, many emerging market (EM) nations gradually re-engaged with international credit markets, and we are now in a situation where **60% of EM sovereign issuers are investment-grade rated (BBB- and above)**, according to Standard and Poors 2017 data. There have also been key advances in the development of EM debt markets; namely the deepening in the maturity spectrum and the issuance of corporate and local currency bonds, with the latter facilitating a long-tenor local risk curve. This allows managers to trade different parts of the curve that may be dependent on different considerations.

More simply, these consequences reflect the integration of EM economies in the global political and economic mainstream.

Corporate debt markets have also faced significant change.

One prominent shift has been in **the role of the banks**. The GFC unveiled significant deficiencies in corporate governance and lending practices within the banking sector, as well as problems derived from the contagion risk of entity failure, and the linkage between sovereign and banking risk.

Since 2008 we have witnessed the concentration of entities, while some countries have faced structural changes in their banking landscapes – the transformation of the Spanish cajas (regional savings banks) reflects this shift.

FIG 5: CONCENTRATION OF THE SPANISH BANKING SECTOR

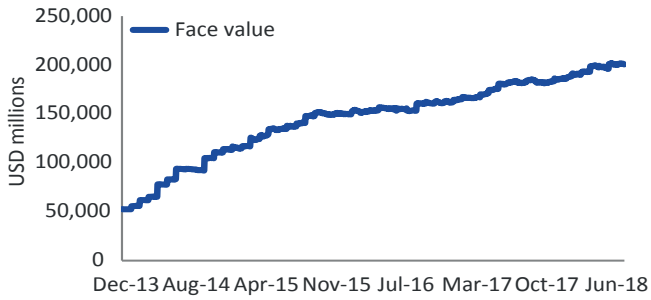
Source: El Confidencial.LAB, August 2018

More demanding regulation from supervisory institutions has prompted changes in the capital structure of the banks and the resolution mechanisms for those entities. The rise of contingent convertible bonds (cocos) is a good example.

Regulatory pressure has also prompted banks to apply stricter lending practices, consequentially opening up a sector of the market to private direct lenders.

In EM, following the trend in sovereigns, more corporate issuers are able to tap the bond market as a source of funding. We view this as positive, as international flows can provide an additional layer of support on top of domestic lenders.

FIG 6: OUTSTANDING COCO ISSUANCE (FACE VALUE)



Source: Bloomberg, as at 29 June 2018

FIG 7: EM CORPORATE PRIMARY MARKET REMAINS ACTIVE

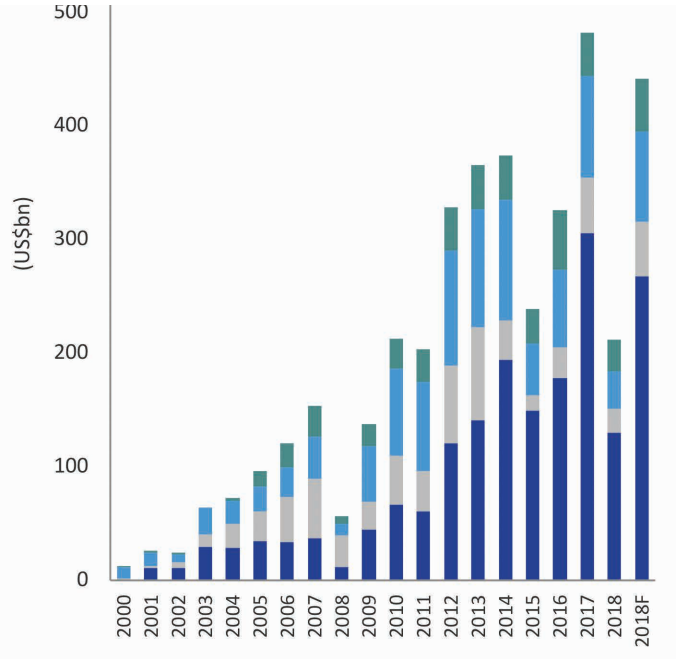
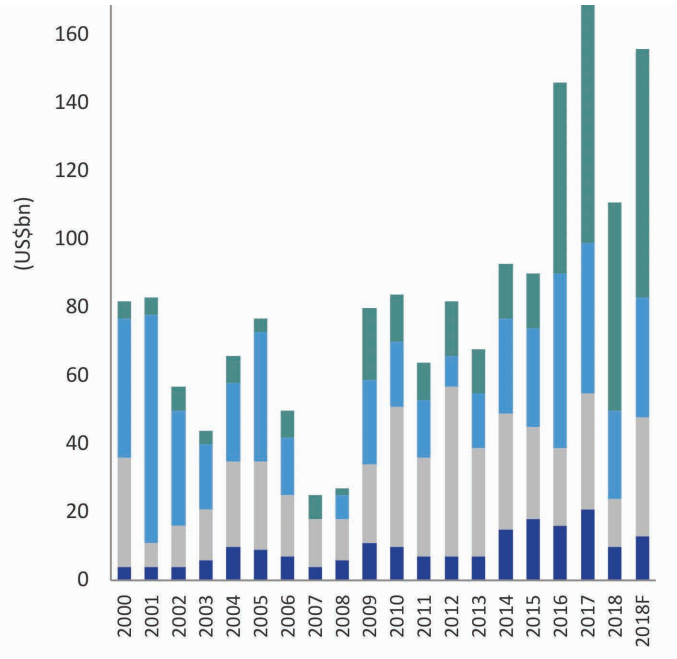


FIG 8: EM SOVEREIGN ISSUANCE CONTINUES AT A RECORD PACE



Source: JP Morgan 2018 YTD as at 6 June 2018

Market dynamics: Alpha over beta

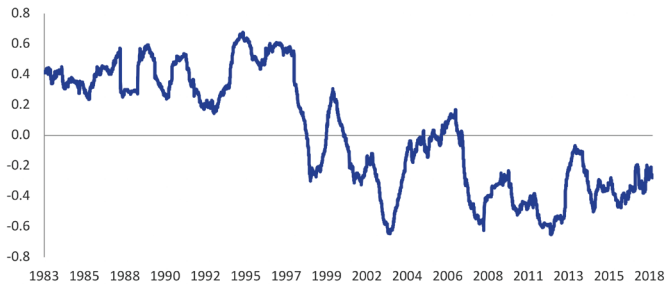
Looking at fixed income markets, there are two potential drivers of returns versus equities:

Driver 1: Changes in the time value of money – which affect all asset classes concurrently.

Driver 2: Changes due to reallocations of risk preferences – which affect fixed income and equities in different ways (for instance in the case of flights to/from quality).

Driver 2 prevailed over the past decade as low rates indicated little time preference. But if we transition to an environment more akin to the 1980s and 1990s with higher rates and inflation, it is likely that driver 1 will gain prominence. If rates are higher, they can comprise a larger portion of the full yield, and the range of variability on rates can also be higher. This higher variability linked to the time preference of money, which affects all assets classes, should result in a shift towards a positive correlation between bonds and equities.

FIG 9: CORRELATION OF US EQUITIES VS. US TREASURIES MAY 1982-JUNE 2018



Source: Bloomberg, S&P 500 TR, ML US 10-yr Treasury futures to 29 June 2018

This will likely lead to an environment where alpha should be a better source of returns than beta. With most asset classes 'priced to perfection' and volatility and dispersion on the rise, the post-QE retreat by central banks has eased the foot that was compressing volatility.

From a management standpoint, a market with higher rates, volatility and dispersion should allow investors to generate returns with less leverage – as sharper moves in a higher volatility environment, aided by larger dispersion between good and bad issuers, would allow more juice per round of leverage, albeit at a higher cost per round.

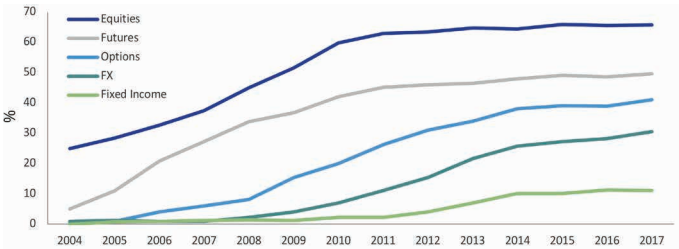
Liquidity

There have been several developments in recent years that impact the liquidity dimension of markets:

- The popularity of passive products and algorithmic trading, which can cause crowding due to the widespread use of certain signals and models (for quantitative funds) or concentration at certain parts of the trading session.
- Inability of banks to warehouse assets due to regulatory restrictions, leading to a need for a real counterparty on the other side of the trade.
- Profusion of daily liquidity products or ETFs, which on occasion venture into areas of the liquidity spectrum that do not match their liability profile.
- The reactive nature of certain high-frequency strategies makes the liquidity provision from those participants uneven depending on the market context.

These developments generate both risks and opportunities that alternative funds should be able to exploit and manage simultaneously. Whereas there is less algorithmic trading of fixed income assets (approximately 10% versus 60%+ in equities), they are not immune to the impact of a buyers' strike. Any subsequent liquidity crisis would tend to lead to temporary dislocations that can be profitable for those participants with staying power. This is why adequate asset-liability management and terms in the funding facilities are of paramount importance, as they enable alternative investors to play offence when others are playing defence.

FIG 10: MARKET SHARE OF ALGORITHMIC TRADING BY ASSET CLASS (%)



Source: Aite Group, Goldman Sachs Global Investment Research, 22 May 2018

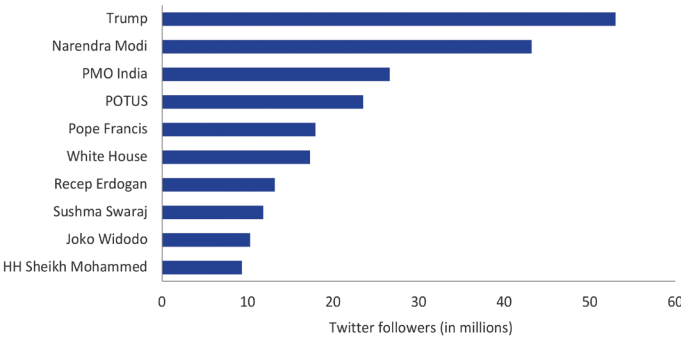
Newsflow: The need for immediacy

Alongside market developments, we have witnessed an evolution in how information impacts market operators, and how this information is digested and transacted in the markets.

While there has been a clear increase in the depth of available information, there has also been a narrowing of focus. Technology now exposes us to more frequently updated information, rather than to deeper or more varied information on each topic. This compresses the shelf life of news items from days down to hours or even minutes and degrades the quality of the information provided, leading us towards the realm of fake news.

Lower barriers to entry for online publishing have caused problems for the business model of traditional news outlets, as well as the mushrooming of low-quality/biased news providers. Perhaps most significant is the disintermediation between economic actors and the general public, often via social media, an example being President Trump's unfiltered tweets. These communications can provide valuable information given the context, biases of the communicator and expected audience response.

FIG 11: WORLD LEADERS WITH THE MOST TWITTER FOLLOWERS



Source: Twitter, 28 June 2018

Skillset – critical thinkers required

As we learn to question our news sources, we must also turn a scrutinising eye on conventional wisdom and challenge foregone conclusions. True critical thinking is essential.

We see systematic and thorough processes as the application of critical thought. Using a repeatable, proven process helps with planning and not being overcome by sudden events. Attention to detail is especially important in areas such as corporate credit or direct lending, where differences in a bond's indenture or the ability to access collateral can be the difference between a good and a bad investment. When the wind does not blow in the market's favour, one can distinguish between those who did their homework and those who didn't.

Having a good grasp on the business/political model of the issuer and the motivation of the decision makers is also of phenomenal importance. Knowing the capital structure of a company inside out helps one to value its assets more precisely and understand the incentives of issuers and holders.

In tandem, a thorough understanding of political circumstances has become essential. Economics is the daughter of politics, and whereas the number of actors in the economic sandbox is in the millions, the number of performers in the political theatre is more reduced. It is therefore essential to understand the drivers and incentives of the agents that manage monetary policy and budgetary decisions.

Intellectual honesty and being coherent with one's thoughts is what may differentiate successful investors in the future. In a moment of crisis, a clear road map of possible trading scenarios is essential for avoiding falling into mind traps, re-blueprinting ideas and searching for new rationales to keep a losing position when the original thesis is broken. Systematically written, supervised, enforceable protocols are key, both for risk management and for the investment business in general.

But we should not forget that we are co-participants in a vast market. Understanding the structure of that market is essential: who are the buyers and sellers, who are the co-owners of our securities, how well funded they are, the balance between retail money, real institutional money and speculators in the demand for securities.

As accommodative policies are removed and the cycle starts to turn, the investment community faces unchartered territory. Continuing with the favoured tools of the past is a risky strategy in the new economic environment, where the ground rules have changed and the future likely features rising rates, elevated volatility and the return of dispersion – an environment where long-only beta products are likely to underperform. We believe the best way forward is to approach the world with a revised mindset, reduce reliance on the flagging beta horse and harness the alpha opportunities markets are presenting through the dynamic investment approach employed by alternative strategies.

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