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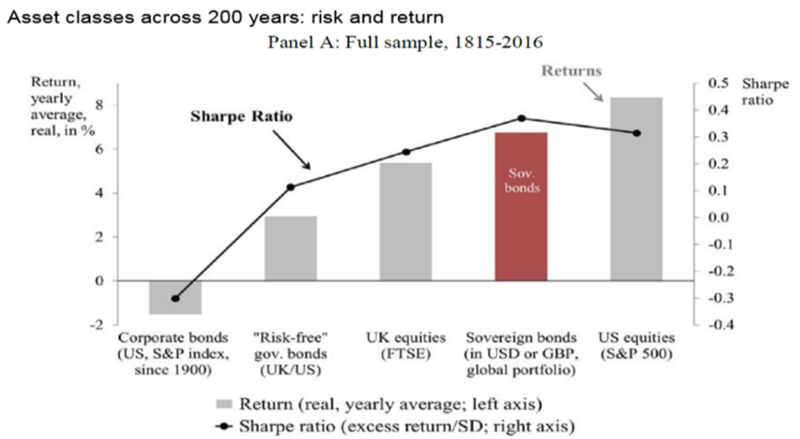
Key takeaways from the Cbonds EM bonds conference in Hong Kong

- Blackfort Capital was invited to participate at the Cbonds EM bond conference in Hong Kong. One key question was if the actual credit cycle will continue or not. If we just look at the actual levels of the OAS corporate high yield spreads globally, we can see that Asian bonds do still offer higher yields than the other areas.
- We can as well see that the spreads were around 100-150 basis point tighter at the beginning of 2018. Most market participants fear that the spreads might widened like last year. We would add that this depends on how the global economy will develop over the coming months. The latest Chinese export statistics show an increase of more than 13% and the first GDP estimate came in at 6.4%.
- Mid-term we expect that the tax cut in China, which is estimated to be larger than 6.5% of Chinas GDP will have a significant impact. We therefore continue to believe that a reacceleration of growth in Asian economies and the US is going to support both corporate (HY) bonds and equities.
- We are therefore overweight in Asian corporates followed by American corporate bonds. The least preferred region is Europe due to its weak growth outlook, structural risks and political uncertainties.

Asian corporate high yields still trade at an attractive OAS spread

Emerging Market sovereign bonds outperform corporate IG bonds



Source: Sovereign Bonds since Waterloo by Josefin Meyer, Carmen M. Reinhart, Christoph Trebesch, February 2019.

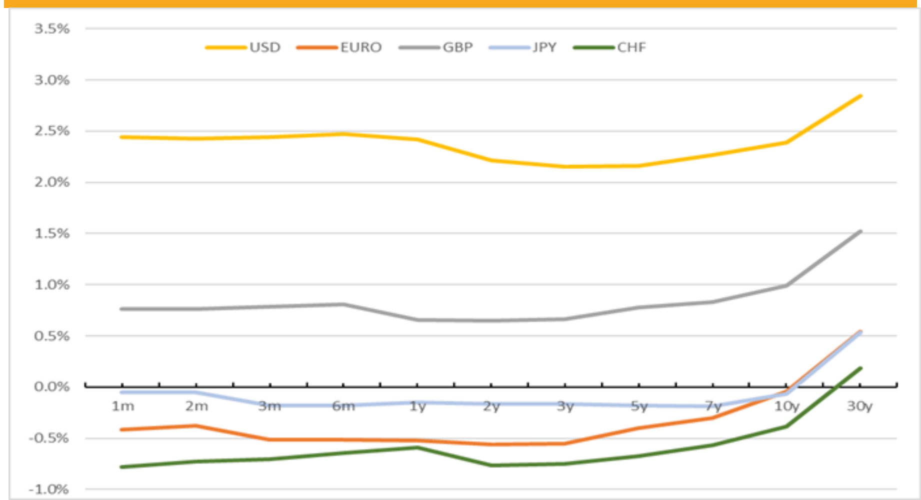
Source Graphic: UBS CIO blog published at 5.4.19: What can we learn from 200 years of emerging market bond history?

- In one of the latest UBS CIO blogs an interesting study regarding real returns and risk was published.
- Over 200 years emerging market sovereign bonds have delivered 6.8% real return almost reaching the level of equities. Remarkable is, however, that on a risk adjusted basis they have outperformed equities as they show by the highest Sharpe ratio.
- Around 70% of the return was achieved by collecting the coupons and 30% came from capital gains. The sample includes all periods, i.e. defaults and bond crisis over the last 200 years.
- The 2nd important point is that corporate investment grade US dollar bonds have delivered negative real returns. Furthermore risk adjusted (using the Sharpe ratio) they are the worst performing asset class.
- High yield bonds have as well outperformed the risk free rate, i.e. government bonds in USD and GBP.
- We are therefore comfortable for the future that corporate high yield bonds will continue to deliver goods returns. We expect that until the end of 2019 an investor should at least earn the attractive coupons and spreads might trade sideways.

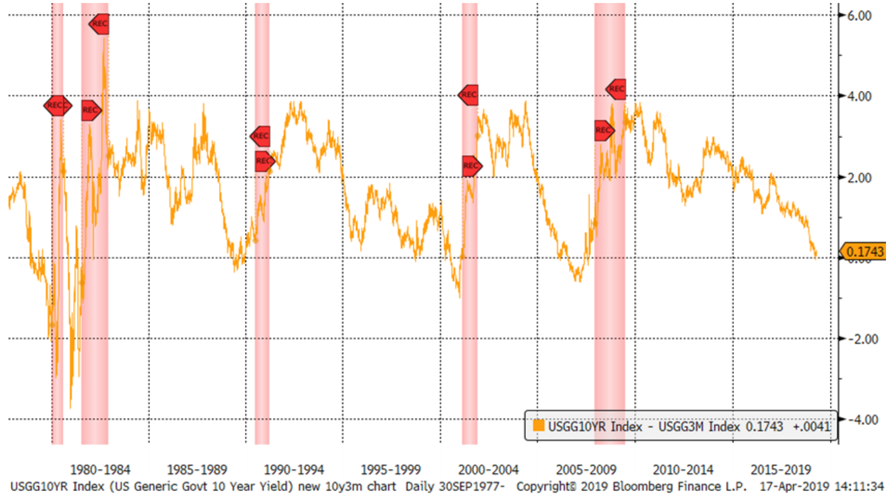
Key takeaways part II: Credit cycle might last due to financial repression

- For predicting the credit cycle we believe it is key to foresee if there is a recession in the US and in China. In China fiscal stimulus in 2019 will be larger than 6.5% of GDP so a recession is very unlikely.
- For the US the best predictor of a recession is the 10-year 3-months spread. It has became negative in recent weeks but so far only for a very short time.
- Since the mid-1980 the yield curve has inverted seven times, only resulting in a recession on three occasions. So far we strongly believe that this time cloud be another false signal, as the inversion happened when the Fed announced it will most likely not hike in 2019 and that in October 2019 they will stop shrinking the balance sheet.
- In October the Fed starts therefore with its implicit QE (i.e. to stop shrinking the Fed balance sheet means reinvesting coupons and maturing bonds).
- With this they will restart with financial repression, i.e. to manipulate the yield curve. Most market participants expect that the Fed will concentrate its buying effort in the 1-month to 2-year bucket, as the yield curve is still partially inverted.
- The author believes that since 2012 we live in a regime of financial repression and that this will keep rates low for much longer. The final target is to create inflation and to reduce the debt to GDP ratio.

Partially inverted yield curves: Financial repression at work



10-year 3 month spread is not any longer inverted



- Therefore we believe that this credit cycle is not over yet. That asset bubbles are a unwelcomed side effect and that emerging market hard currency bonds are a good way to deploy money under such a regime.

- **Definition of Financial Repression**
  (based on a Rothschild research paper from 2012):
  "In our usage, **financial repression describes a situation where interest rates are kept artificially depressed**. This works through governments intervening directly in the market for public debt, and via the knock-on effects of their actions on the monetary authorities. It takes a wide range of forms, including **central banks directly buying government bonds** (which pushes yields and borrowing costs lower),
  Financial repression works best when combined with modestly elevated rates of inflation that persist for a number of years. This means headline inflation rates around 1% to 3% above official targets"

Blackfort Capital's CIO during a panel discussion at the Cbonds EM bond conference

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