Man | GLG

THE DANGERS OF SHORT-TERM MEMORY

By Lisa Chua

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INTRODUCTION

Winston Churchill once noted, "The farther backward you can look, the farther forward you are likely to see." Yet the level of risk accumulation in the markets suggests that many investors may have taken a much more near-sighted approach to investing – one that focuses only on the recent past. Namely, a period characterized by a global quantitative easing ('QE') program and abnormally low interest rates and levels of volatility. The market conditions leading up to 2008 and the financial crisis that preceded the lifeline from the Fed seems to be a distant memory many wish to forget.

It's been 10 years since the global financial crisis, and QE has helped drive a nine-year economic recovery during which US unemployment has fallen from 10% to sub 4%. That said, we are of the view that economic strength does not equate to bullet-proof markets, and the run-up in financial markets, prompted by years of excess global liquidity, leaves risk assets in a precarious position a decade later.

In the grab for yield, emerging market high yield debt issuance surged to record levels last year. Easy market access enabled many emerging market economies and high yield issuers to borrow irrespective of their level of fiscal discipline. At the same time, low-fee passive investing via the growth of exchange-traded funds ('ETFs') has allowed more and more investors and those dabbling in investing to join the chase. The asset growth of emerging market debt ETFs accelerated at a time when market frothiness was simultaneously enabling more and more ticking bombs to enter its asset class.

Even more worrisome, it hasn't just been pioneers to the asset class who have fallen victim to long-term memory loss, but also the alleged experts entrusted to manage the risks. Emboldened by a benign macro environment, which translated to abnormally low volatility, low defaults and an ability to convert yields into returns, many active managers piled on risk as well, relying on being overweight beta and yield to generate outperformance.

Here we take a closer look at the state of the markets in 2018, and lessons investors should have learned in 2008 but may have forgotten (or chosen to ignore). Given increasing risks and our expectation of more normalized levels of volatility versus the recent lows, we also offer our proposal for a more dynamic active management approach, with an emphasis on alpha generation and country selection.

JUMPING DOWN THE RABBIT HOLE IN A CHASE FOR YIELD

Leading up to the 2008 financial crisis, the demand for higher yielding mortgage-backed securities ('MBS' products) spurred an insatiable demand for subprime mortgages and drove an overextension of credit. Fast-forward 10 years and we are left with much more regulated financial markets, but one facing similar vulnerabilities.

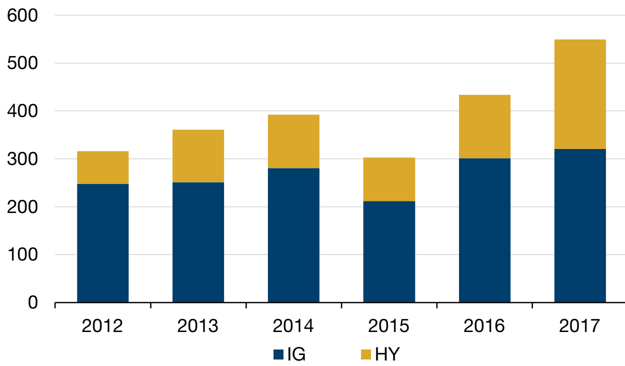
Following the crisis, a massive global QE program ensued during which the major central banks globally (Fed, ECB and BOJ) expanded their balance sheets and depressed yields in developed markets (in some cases pushing yields negative). A sustained period of artificially low yields and volatility created an insatiable demand for higher yields, inflating risk assets and pushing investors further and further down the credit quality spectrum as spreads compressed. The only difference between the early 2000s and today is that the build-up of excess liquidity in the system has come not from the private sector, but from the public sector.

Emerging markets have benefitted along with other risk assets in the grab for yield. The bull case for emerging markets was clear – many EM countries had undergone a structural transformation since their crisis period in the late 1990s and at the turn of the century. EM bellwethers had shored up reserves, riding on the tailwinds of the China growth story and the boom in commodities. More importantly, many EM countries had moved from fixed to floating FX regimes in the early 2000s. Floating FX regimes granted them the ability to restore macroeconomic imbalances and current account deficits through adjustments in the FX, thereby improving their creditworthiness and ability to pay back their external debt.

By 2011 though, the picture started to change and external vulnerabilities again started to creep higher, as China growth and commodities slowed. Global quantitative easing further exacerbated the rise in debt-to-GDP ratios for many emerging market countries, as many issuers were given a get-out-of-jail free card in the form of easy debt rollovers and market access, irrespective of fiscal discipline and credit quality. Investors were again jumping down the rabbit hole in the chase for yield.

After stalling in 2015 on the back of a commodity led sell-off, emerging market issuance of sovereign and corporate hard currency bonds continued its upward climb. 2017 issuance of emerging market bonds was a record year, with issuance up 27% yoy, driven by the high yield sector which surged an impressive 73% yoy.

Exhibit 1. EMD Hard Currency Issuance Trends, USD equiv (bn)

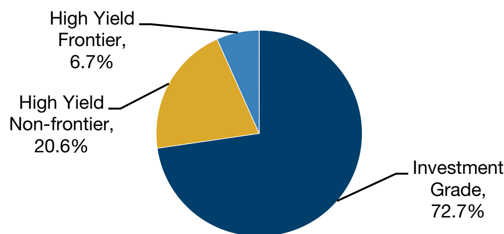


Source: Bloomberg; includes emerging market sovereign and corporate bonds with issue sizes of USD300mm or more, as of 12.31.2017.

Tajikistan's debut Eurobond is an example of 2017 market exuberance. Only in a bizarro world of negative developed market yields would tiny, B- rated countries like Tajikistan be able to issue at 7%. Underwriters were courteous enough to include a map in the prospectus so potential lenders could locate it, leaving the rest to their imagination as to how a barely USD7bn economy with low reserves, twin deficits, and a dependence on remittances from migrant Russia workers would eventually pay them back. And only under generous market conditions would such a deal reportedly have USD5bn in orders, or 10x the deal size (mind you, reported demand equated to over 70% of the country's GDP), only to almost immediately trade lower in the secondary.

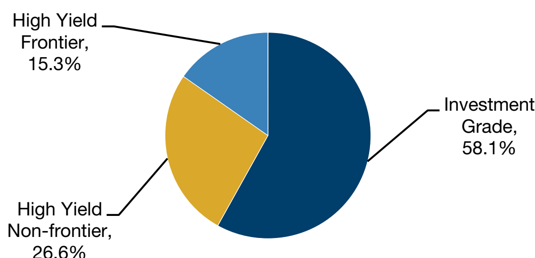
It is hard to dispute that the overall credit quality of the emerging market hard currency universe has deteriorated, driven by both downgrades and increased issuance from frontier, or next generation, emerging markets ('NEXGEM'). The high yield component of the JP Morgan EMBIG benchmark (emerging market USD bonds) has increased from 27% to 42% over the past five years, with frontier markets more than doubling from 7% to 15% of the benchmark.

Exhibit 2. Emerging Market USD Bonds as of 7.31.13



Source: JP Morgan EMBIG.

Exhibit 3. Emerging Market USD Bonds as of 7.31.18



Source: JP Morgan EMBIG.

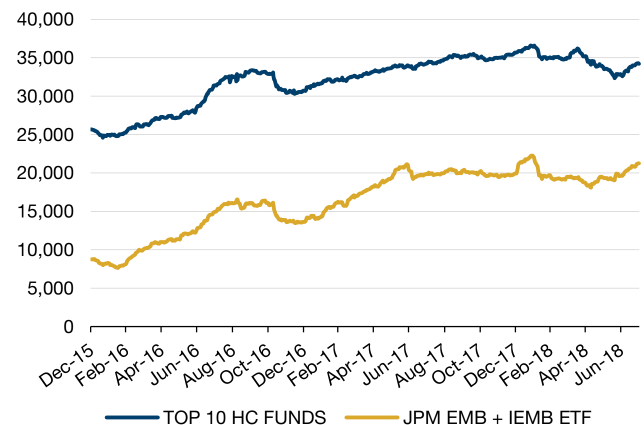
Moreover, while the country weights of the EMBIG are based on market capitalization of outstanding USD-denominated debt, many EM hard currency bond managers select the EMBIG Diversified as their benchmark, as it caps the weight of the larger countries. Although this results in more diversified country weightings, it implicitly increases the weight of smaller, high yield frontier countries in the EMBIG Diversified to 25% vs. 15% in the EMBIG. The increase in issuance and benchmark representation of less liquid, high yield frontier emerging market bonds is particularly concerning to us, as many of the frontier markets have twin deficits and pegged FX regimes. Should market access and debt rollovers become more challenging, default risk increases, especially for the countries with weaker credit fundamentals and limited means of restoring macroeconomic imbalances given pegged FX regimes. We believe investors need to pay closer attention to differentiating among the countries and dodging the bullets, rather than hugging an imperfect benchmark with an increasing representation of this more fragile segment of the asset class.

A BLIND EYE TO THE RISKS DOESN'T MAKE THINGS ANY LESS RISKY

We believe the grab for yield in and of itself is not a concern, but it becomes one when done with a blind eye to the risks, and due diligence or risk reward assessments are lacking. In the years leading up to the 2008 financial crisis, subprime mortgages were packaged into alleged investment-grade quality securitizations, and investors piled on, not necessarily understanding the embedded risks but enticed by the AAA ratings. A decade later, the latest bang-for-your-buck products are low-fee exchange-traded funds ('ETFs') that promise cheap access to the various asset classes via passive benchmark investing.

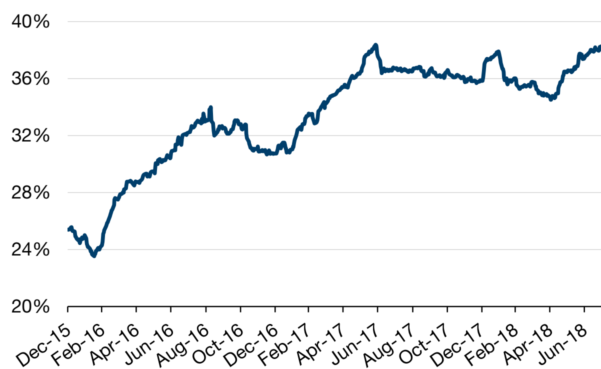
Inflows into emerging market ETFs have been growing at an unprecedented rate. JP Morgan launched its USD Emerging Markets Bond ETF ('EMB') for US investors in December 2007, and shortly after in February 2008 launched a UCITS version of the ETF ('IEMB'). These two widely tracked emerging market bond ETFs have grown from a negligible subset of the investor base to over USD20bn in AUM. Most recently, the asset base of these two ETFs has more than doubled in a little over two years, with passive investing, as measured by EMB + IEMB assets, rapidly increasing its market share relative to active managers, as measured by assets of the top ten hard currency fund managers.

Exhibit 4. Evolution of Active vs. Passive Investing (USD m)



Source: Bloomberg and Man GLG, as of 7.31.2018.

Exhibit 5. % ETF



Source: Bloomberg and Man GLG, as of 7.31.2018.

While ETFs serve as an easy way to get beta to an asset class, herd behavior becomes dangerous when positioning gets overly crowded in our view (leaving the asset class vulnerable to a change in direction). The growth of passive investing in emerging market bonds also exacerbates liquidity concerns and gappy price action – both on the way up when everyone chases limited supply of the same issuers and on the way down when they look to sell with no marginal end buyer left to take the other side.

Even more concerning is that investing in emerging market bond ETFs entails blindly replicating a benchmark that has been deteriorating in overall credit quality (given the increased weight of high yield and less liquid frontier countries). Enticed by the attractive yield of emerging market debt, passive investors in an ETF are essentially buying up bonds simply because a country issued them and they were included in an index. The recent acceleration of passive investing, and the chase for benchmark issuers without differentiating between credit quality, inflates prices to levels not commensurate with the risks, particularly in the less liquid, high yield and frontier segments of the markets.

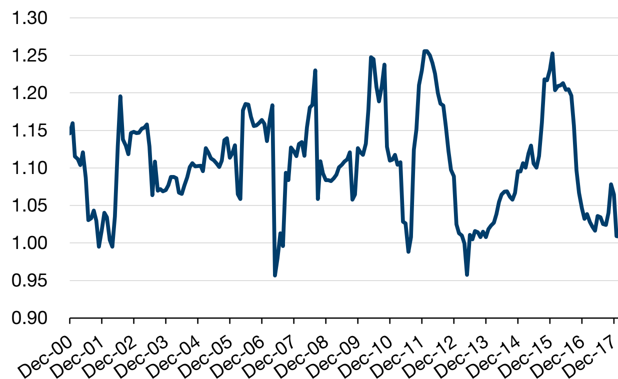
Chasing a BB+ rated EM benchmark for its yield, without understanding what's driving that yield, is hauntingly similar to chasing subprime products masked as AAA. As of 7.31.18, the headline yield on the JP Morgan EMBIG was 6.5%, with a seemingly enticing z-spread of 346bps. It is worth noting though that Venezuela, a country in default and no longer current on payments, comprised just 1.7% in market value terms of that benchmark, but contributed 25% of the headline spread.

In the blink of an eye, the default rate (par-weighted) for emerging market USD bonds went from 0.1% in 2017 (Mozambique) to 6.0% by 2018 with the default of Venezuela and its 100%-government owned oil company, PDVSA. Beyond just Venezuela, we believe defaults within emerging markets are likely to be higher than they have been in the recent past given the increased issuance from weaker segments of the markets (high yield and frontier).

Markets had become accustomed to a benign macro environment of abnormally low volatility, low defaults and an ability to convert yields into returns. Turkey is a country with large external vulnerabilities and rollover needs, and a good reminder of how quickly volatility can spike and prices plummet when the market starts to doubt access to markets. In a world of tightening global monetary conditions, the market may be less forgiving in extending credit indiscriminately, and yields will not necessarily convert to returns.

Unfortunately, ETFs are not the only ones guilty of taking an ostrich approach to investing. Many active managers have also gotten wrapped up in the chase for yield, burying their head in the sand to the mounting risks of doing so. Since 2000, many EM hard currency bond managers have run betas between 1.0x-1.25x.

Exhibit 6. Average 12-month rolling beta for selected EM hard currency managers vs. benchmark

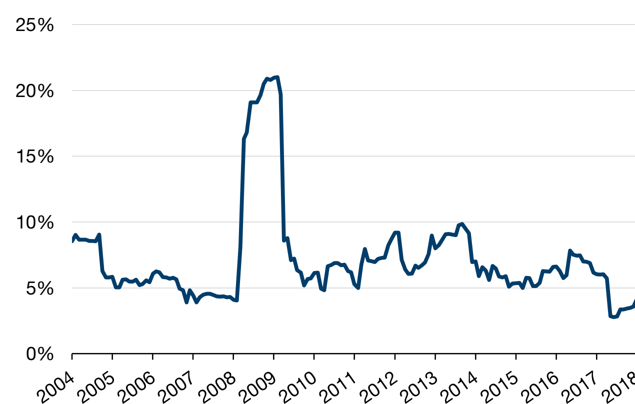


Source: eVestments and Man GLG; Represented by 23 managers within the eVestment Emerging Markets Fixed Income – Hard Currency universe that have provided gross monthly performance to eVestment starting in January 2000, managed their strategies against JP Morgan EMBIG Div or JP Morgan EMBIG benchmarks, and had a hard currency product AUM of USD500mm or more as of 6.30.2018.

The 'active' investing approach that many EMD hard currency benchmark managers have taken to outperform is to run higher betas and higher yield than the benchmark, in the hopes of being able to consistently convert that yield to return. As we have written about in the past, our proprietary tools and multivariable regression analysis of EMD hard currency managers suggest to us that the current betas of many of these managers are still above 1, and likely even understated due to large overlays in corporates and high yield frontiers. A lack of trading in these less liquid segments of the asset class mutes their beta contribution, and the true beta is only captured when forced selling tests the actual liquidity.

ETFs and beta plays work in a one directional upward market, but in our opinion are not sufficient to generate strong risk-adjusted returns over a cycle. Volatility has been abnormally low due to years of global quantitative easing and excess liquidity. The 12-month rolling volatility of emerging market USD bonds spiked from a record low of 2.8% at the start of the year to 4.2% at 7.31.18, but still remains well below the more typical 6%-8% range for the asset class (Exhibit 7). We believe true active management and alpha generation will be crucial going forward to navigate rising volatility and a wider spectrum of credit quality.

Exhibit 7. Emerging Market USD Bond ('EMBIG') 12M Rolling Volatility

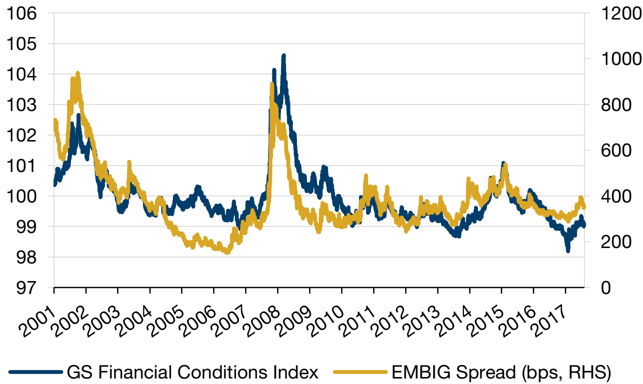


Source: Bloomberg and JP Morgan, as of 7.31.2018.

RACING AT FULL SPEED WITHOUT AIRBAGS

The solution to the 2008 financial crisis was to regulate banks and provide a massive bailout and a multi-tranche quantitative easing program. It solved one problem, but paved the way for future ones. Accommodative financial conditions, including an expansion of central bank balance sheets across the Fed, ECB and BOJ, drove a liquidity-induced rally across emerging markets and other risk assets. Financial conditions are still loose from a historical perspective, and as conditions continue to normalize, we would expect this to put upward pressure on emerging market USD bond spreads.

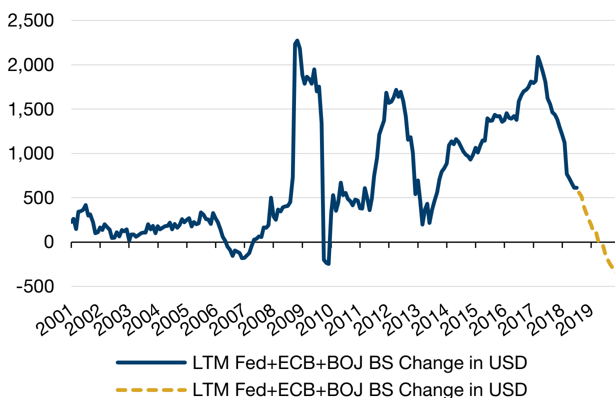
Exhibit 8. Goldman Sachs US Financial Conditions Index and EMBIG spreads



Source: Bloomberg, as of 7.31.2018.

The rolling 1-year balance sheet change of the three major central banks reached its peak expansion of over USD2 trillion in 2017, but now the dynamics are starting to shift. The Fed is already shrinking its balance sheet and the ECB is tapering, decelerating the pace of the cumulative expansion and bringing it on track to shrink by 2019.

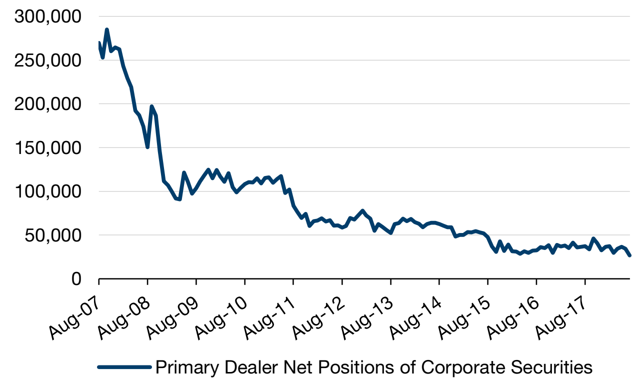
Exhibit 9. Rolling 1-yr change of FED+ECB+BOJ balance sheet in USD, bn



Source: Bloomberg and Man GLG, as of 7.31.2018; projections for August 2018 through December 2019 assume that the Fed sticks to its plan, ECB winds down tapering in 4Q18, and BOJ continues to inject liquidity at the same pace observed in 2H17, with tapering starting in April 2019.

When developed market central banks hit the brakes on injecting liquidity, who will absorb the impact? The inflows into emerging markets and other risk assets that ensued in the grab for yield are vulnerable to a reversal. Perversely, the regulation of the banks may exacerbate a sell-off, as broker dealers have less ability and willingness to warehouse risk, particularly given the imbalance of the buy-side relative to the sell-side. We believe the decline in primary dealer balance sheets is best evidenced by available data on their corporate inventory, which has fallen to 10%-15% of peak levels in 2007.

Exhibit 10. Primary Dealer Net Positions of Corporate Securities



Source: Federal Reserve Bank of New York and Haver; including non-agency MBS based on historical method of calculation, as of 7.31.2018.

CONCLUSION: NAVIGATING CHOPPIER WATERS

We believe active management and a total return approach to investing, with a focus on fundamentals, valuations and positioning (crowded vs. uncrowded) will help to better understand whether risk-reward is attractive. The ability to dial risk up or down without the constraint of a benchmark, and to differentiate between the various country credits and avoid the landmines, can be key for generating strong risk-adjusted returns over a cycle and attractive upside/downside capture ratios.

Staying nimble in a more volatile market environment calls for keeping a close eye on positioning. When positioning is crowded, asset prices may become vulnerable to a correction due to a lack of marginal end buyers. Significant risk accumulation in the market also typically coincides with stretched valuations, and taking risk down in such an environment is prudent in our view. On the other hand, as valuations correct and risk gets unwound, positioning becomes less crowded and opportunities to add risk increase as sellers line up to exit. In our view, only after the sellers get flushed out and positioning is uncrowded, are asset prices best poised for a rally. Finally, we believe portfolio construction with an emphasis on the more liquid segments of the asset class, as opposed to less liquid corporates and frontier markets, facilitates dynamic active management and the ability to move in and out of risk.

For investors who need to manage global asset allocation and require a benchmark, we caution against strategies that consistently rely on being overweight beta and yield. Such an approach relies on methods which worked during the recent past of excess global liquidity and low volatility, but may fail to adapt to increasing risks and a changing macro landscape. As excess global liquidity gets absorbed and volatility returns to more normalized levels, the markets may become more discerning in extending credit, and yields will not necessarily convert into returns for the weaker issuers. Fundamental analysis must also be done in conjunction with valuations and positioning. A static approach of consistently being overweight beta typically results in sharp drawdowns, as it neglects to distinguish times of stretched valuations or crowded positioning, resulting in trapped longs.

The recent acceleration of passive investing via ETFs, and indiscriminate buying irrespective of credit quality, propped up valuations to levels not commensurate with the risks, particularly in the less liquid high yield and frontier segments of the market. The bar should be set ever higher for active managers to distinguish themselves from passive managers. In our view, active EMD hard

currency managers should not settle for hugging an imperfect benchmark, but need to take more convicted country views. For both total return and benchmark fund managers, a risk-adjusted approach to investing, with an emphasis on alpha generation and country selection, will be necessary to outperform.

In a world of tightening global monetary conditions, risk assets become highly correlated. Like a herd of wildebeests at the river migration, only some make it to the other side. The light at the end of the tunnel will be there for those active managers who stay disciplined when investing, and differentiate between the higher-quality bellwether EM countries and the issuers who took advantage of a frothy market. As positioning gets cleaned up and valuations continue to normalize, our target will be to add risk at more attractive levels in select emerging market countries – those with strong balance sheets and floating FX regimes, capable of paying back their external debt even under more challenging circumstances.

Lisa Chua

Portfolio Manager

Lisa Chua is a Portfolio Manager on the Emerging Markets Debt team. Prior to joining Man GLG, Lisa was a Senior Vice President and Portfolio Manager on the Emerging Markets Debt team at HSBC Global Asset Management (USA) Inc. where she was responsible for external markets. She joined HSBC in May 2007 as an Investment Analyst focusing on corporate credit, structured and private securities. Prior to HSBC, Lisa worked as a Research Analyst at Delaware Investments, where she focused on emerging markets debt and private investments since 2003. She holds a BA from the University of Pennsylvania and is a CFA charterholder.

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One should carefully consider the risks associated with investing:

Capital at risk – The value of your investment and the income from it may rise as well as fall and you may not get back the amount originally invested.

Counterparty Risk – Trading on-exchange traded instruments such as futures and options and where applicable, ‘over-the-counter’(‘OTC’, ‘non-exchange’) transactions will give exposure to credit risk on counterparties OTC instruments may also be less liquid and are not afforded the same protections that may apply to participants trading instruments on an organised exchange.

Currency Risk – The value of investments designated in another currency may rise and fall due to exchange rate fluctuations. Adverse movements in currency exchange rates may result in a decrease in return and a loss of capital. It may not be possible or practicable to successfully hedge against the currency risk exposure in all circumstances.

Emerging Markets – Exposure to emerging markets involve additional risks relating to matters such as the illiquidity of securities and the potentially volatile nature of markets not typically associated with investing in other more established economies or markets.

Liquidity Risk – In markets that are volatile and which may become illiquid, timely and cost efficient sale of trading positions can be impaired by decreased trading volume and/or increased price volatility.

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