Are Corporate High Yields still attractive? Blackfort.

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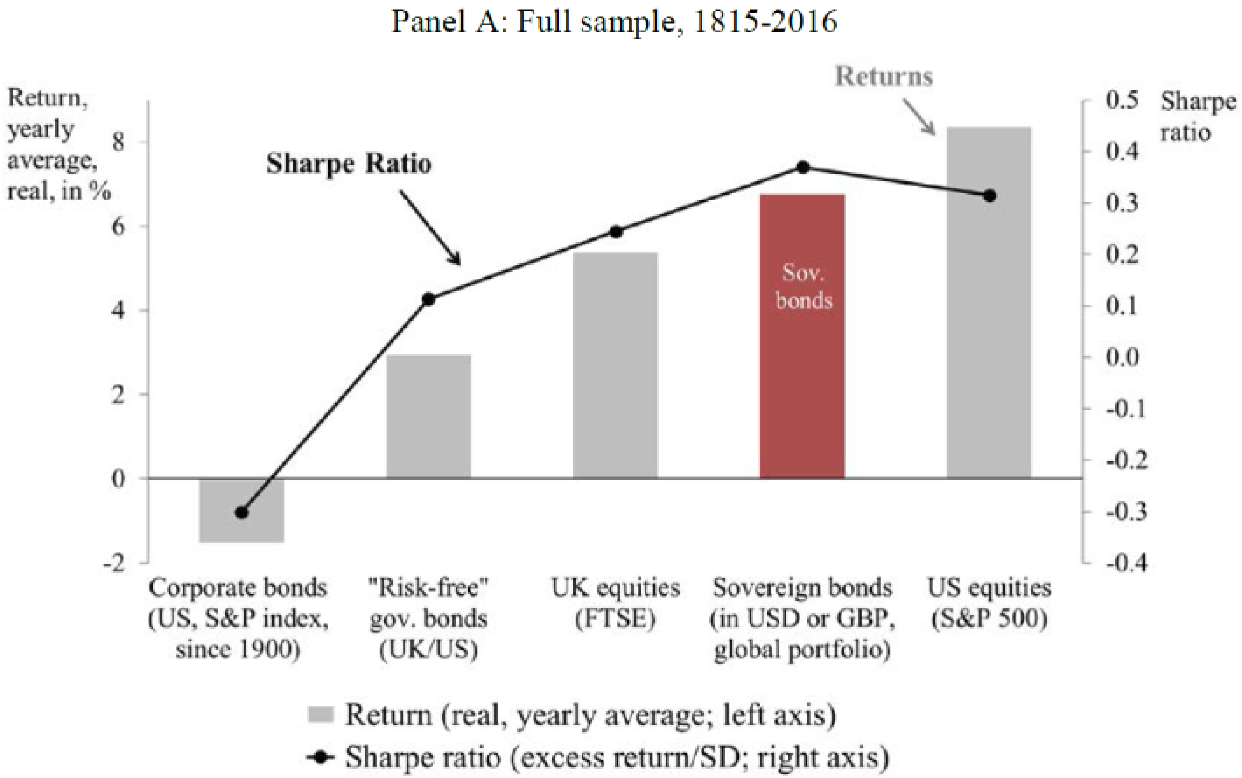
Historic returns of emerging market bonds show the highest Sharpe ratio

A portfolio of emerging market hard currency sovereign bonds has delivered 6.8% p.a. (real return i.e. after inflation) over 200 years outpacing the risk free USD (and GBP) return by 4%!

Asset classes across 200 years: risk and return



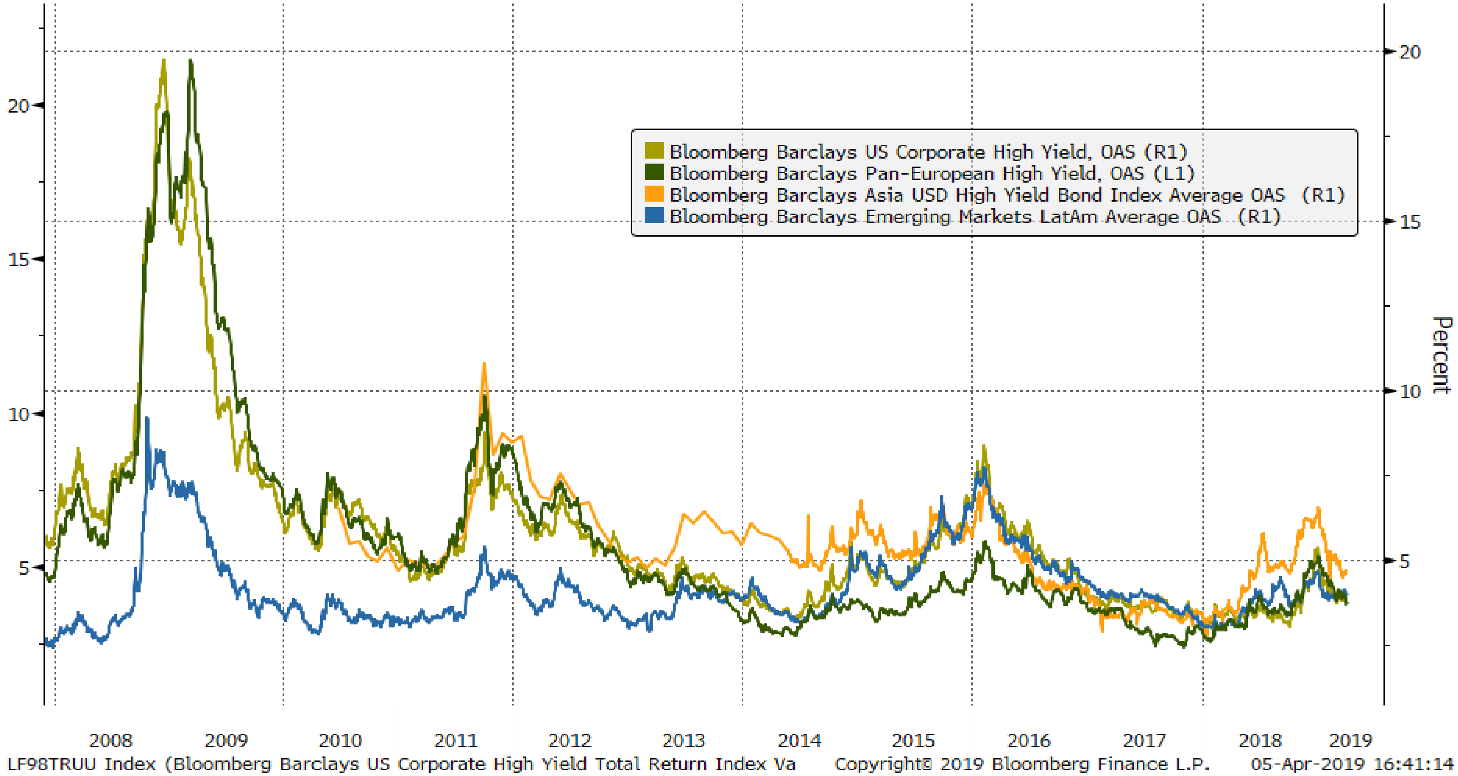
The main contribution to this superior return (70%) comes from coupons payments! Only 30% from price changes.

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?

Corporate HY spreads since the financial crisis: Asian bonds are the most attractive

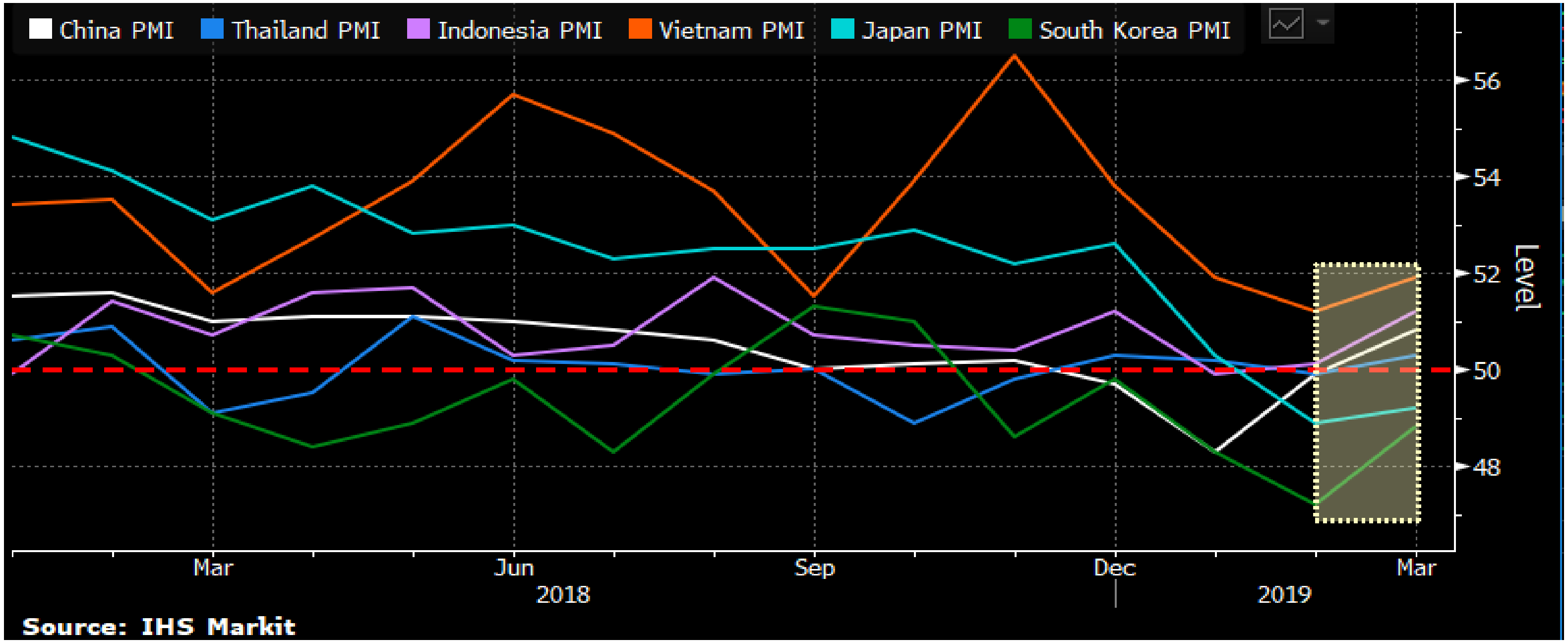
Since 2008 the OAS spread has tightened: Are HY bonds still attractive?



- The answer depends on your growth outlook, your expectations regarding central banks monetary policy and as well to what extent we will see more fiscal stimulus

Monetary and fiscal stimulus in China: Western world is skeptical

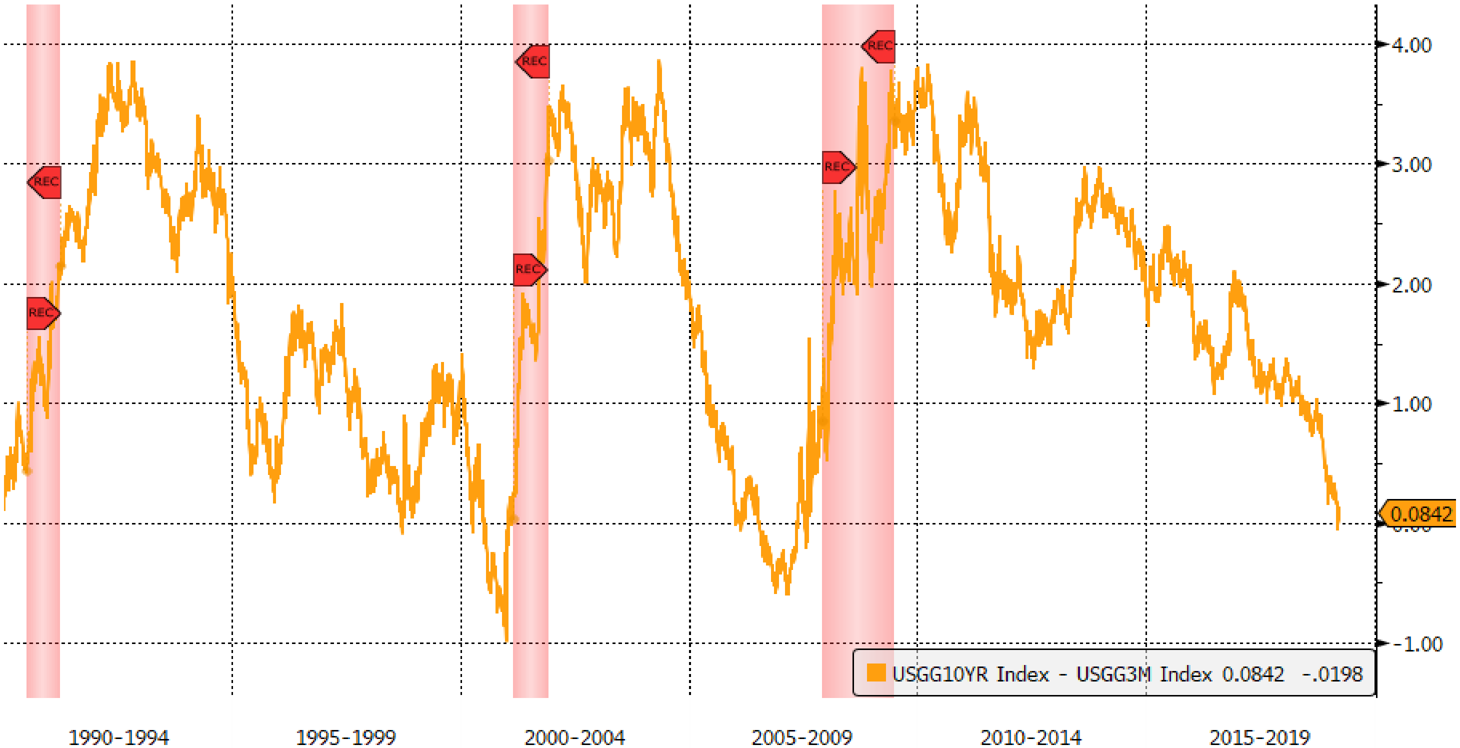
Asian industrial PMIs (plus US ISM Non Manufacturing PMI) do not indicate a further slowdown



- The overall effect of the fiscal impulse in China, announced at 5th of March, is expected to be larger than 6.5% of GDP
- Western analysts have questioned the effectiveness of such an additional impulse
- Based on our financial repression scenario we have expected more stimulus not only in China, but also in Europe
- TLTRO III program from the ECB and the continuation of negative rates are therefore a logical consequence, as well as the Draghi- and Powell-Puts (i.e. implicit QE)

What does the US yield curve tell us?

After the last Fed press conference the 10-year 3-month spread went negative for a short period of time

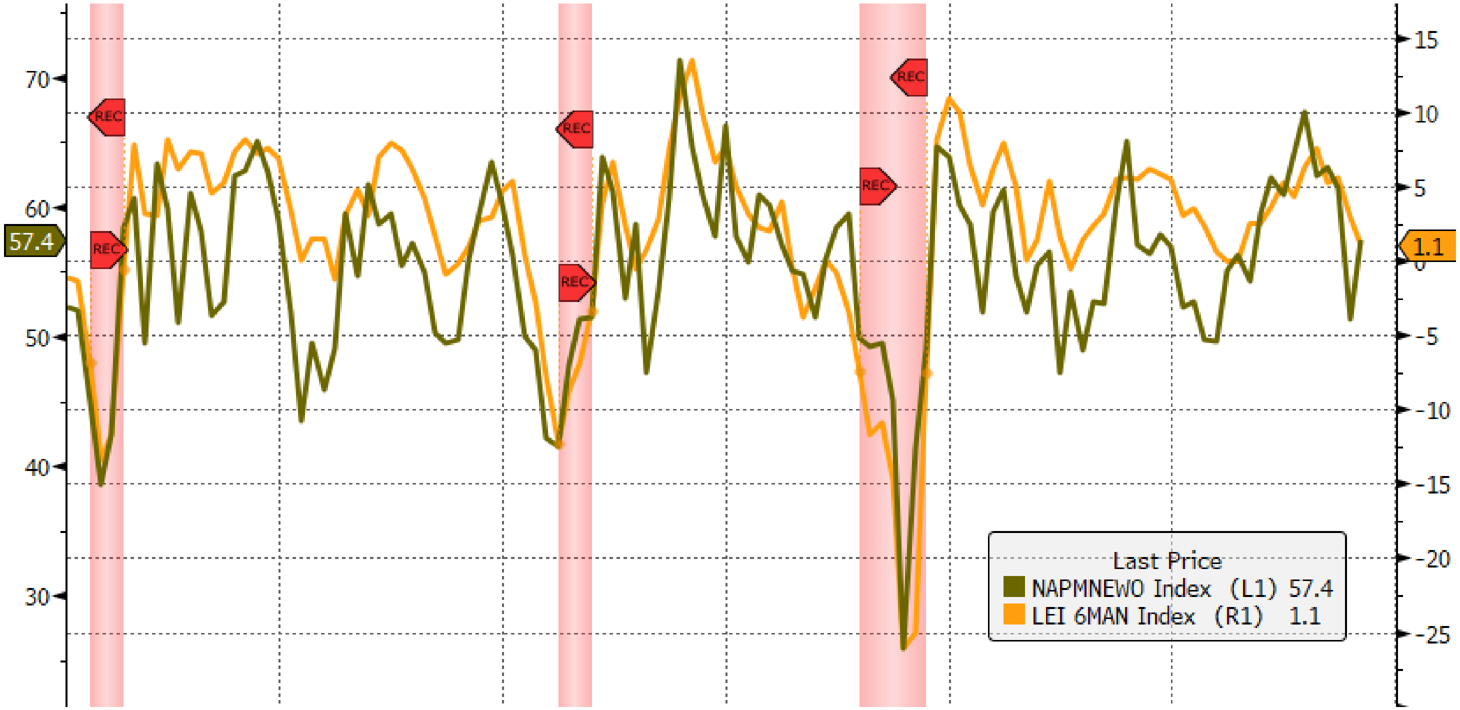


USGG10YR Index (US Generic Govt 10 Year Yield) new 10y3m chart Daily 31DEC1989- Copyright© 2019 Bloomberg Finance L.P. 04-Apr-2019 10:15:17

- Since the mid-1980’s the yield curve has inverted seven times, only resulting in a recession on three occasions

What do US leading indicators tell us?

ISM Non Manufacturing New Orders Index confirms a recovery over the next months



NAPMNEWO Index (ISM Manufacturing Report on Business New Orders SA) US Leading r Copyright© 2019 Bloomberg Finance L.P. 04-Apr-2019 10:16:19

❖ Meanwhile the Conference board leading indicator is still falling

The real problem for central banks is disinflation and not inflation

How can policy rates be raised when we have disinflation globally?

Headline inflation (%YoY)

	Jan 19	Jul 18	Jan 18	Jan 19 on Jul 18	Jan 19 on Jan 18
USA (PCE)[1]	1.8	2.4	1.8	-0.5	0.1
USA (CPI)	1.3	3.2	2.2	-1.9	-0.9
Eurozone	1.4	2.2	1.3	-0.8	0.1
Japan	0.2	1.0	1.4	-0.8	-1.2
Australia[2]	1.8	2.1	1.9	-0.3	-0.1
China	1.7	2.1	1.5	-0.4	0.2
Hong Kong[3]	3.0	2.7	1.6	0.4	1.4
India	2.0	4.2	5.1	-2.1	-3.0
Indonesia	2.8	3.2	3.3	-0.4	-0.4
Korea	0.8	1.1	0.8	-0.3	0.0
Malaysia	-0.7	0.9	2.7	-1.6	-3.4
Philippines	4.4	5.7	3.4	-1.3	1.0
Singapore	0.4	0.6	0.0	-0.3	0.4
Taiwan	0.2	1.8	0.9	-1.6	-0.7
Thailand	0.3	1.5	0.7	-1.2	-0.4

Notes: [1] November 2018 compared with May 2018 and November 2017; [2] 4Q18 compared with 2Q18 and 4Q17; [3] Inflation excluding one off government rebates
Source: CLSA, CEIC, Bloomberg

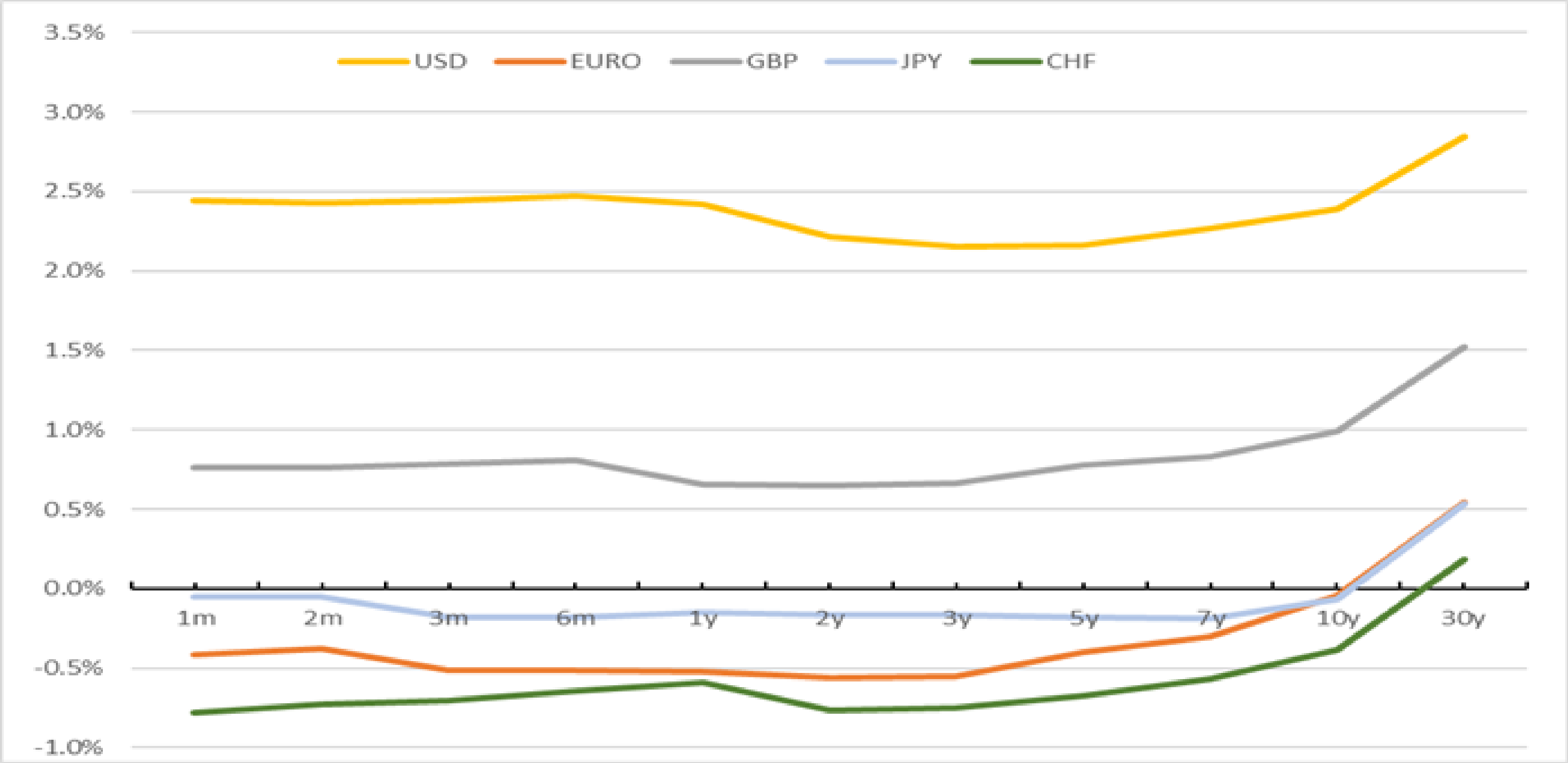
Core inflation[1] (%YoY)

	Jan 19	Jul 18	Jan 18	Jan 19 on Jul 18	Jan 19 on Jan 18
USA (PCE)[2]	1.9	2.0	1.6	-0.2	0.2
USA (CPI)	2.1	2.3	1.8	-0.2	0.3
Eurozone	1.1	1.1	1.0	-0.0	0.1
Japan	0.3	0.0	0.1	0.3	0.2
Australia[3]	1.7	1.6	1.6	0.1	0.1
China	1.9	1.9	1.9	0.0	0.0
Hong Kong[4]	3.0	2.2	1.1	0.8	1.9
India	5.1	5.9	5.0	-0.8	0.1
Indonesia	3.1	2.9	2.7	0.2	0.4
Korea	1.0	1.0	1.0	0.0	0.1
Malaysia	0.2	-0.2	2.2	0.3	-2.0
Philippines	4.4	4.5	2.6	-0.1	1.8
Singapore	1.7	1.9	1.4	-0.2	0.3
Taiwan	0.5	1.5	0.8	-1.0	-0.3
Thailand	0.7	0.8	0.6	-0.1	0.1

Notes: [1] MAS core inflation in Singapore, otherwise inflation ex food and energy 2 November 2018 compared with May 2018 and November 2017; [3] 4Q18 compared with 2Q18 and 4Q17; [4] Core inflation excluding one off government rebates
Source: CLSA, CEIC, Bloomberg

In JPY, EUR and CHF all government bonds up to 10-year have negative yields

Artificially depressed government bond yield levels: Financial Repression at work



- In all 5 shown yield curves the shorter end has a higher yield level, than a 5 year government bond
- In JPY, EUR and CHF financial repression still works well. Government bonds with a maturity of 10-years or shorter do all have negative yields

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Central banks accommodative stance and fiscal stimulus will stay for longer

Since the financial crisis we live in a regime of financial repression

- Financial repression describes a situation where interest rates are kept artificially depressed. QE is a pure form of such an intervention pushing yields and borrowing cost lower.
- We still see this in Japan and the Eurozone. In October the Fed starts with its implicit QE (i.e. to stop shrinking the Fed balance sheet)
- China and the US have already reached the next level of intervention via fiscal policy. The latest Chinese stimulus is estimated to be lager than 6.5% of GDP!
- In the US a 2nd tax reform is discussed and the Fed is under political pressure to decrease rates or since a new tweet from the president, to restart with QE.
- Public and in some countries also private debt have reached levels where higher rates would bring countries and private companies into trouble to serve these debts.
- The political pressure to keep rates artificially low will hinder rates to rise.

Central banks accommodative stance and fiscal stimulus will stay for longer

Since the financial crisis we live in a regime of financial repression

- The key question is: How can this debt burden be reduced?
  - → Inflation combined with low yields (i.e. financial repression) would solve the problem, but so far all stimulus has not created inflation.
  - → But we see asset prices to rise and keep zombie enterprises alive
  - → This will end in euphoria and in a burst of a bubble. But so far we play musical chair and the music is still playing
  - → For 2019 we expect that there will be no recession, tariff conflicts will be solved and the US election cycle will be positive for the economy and for asset markets.

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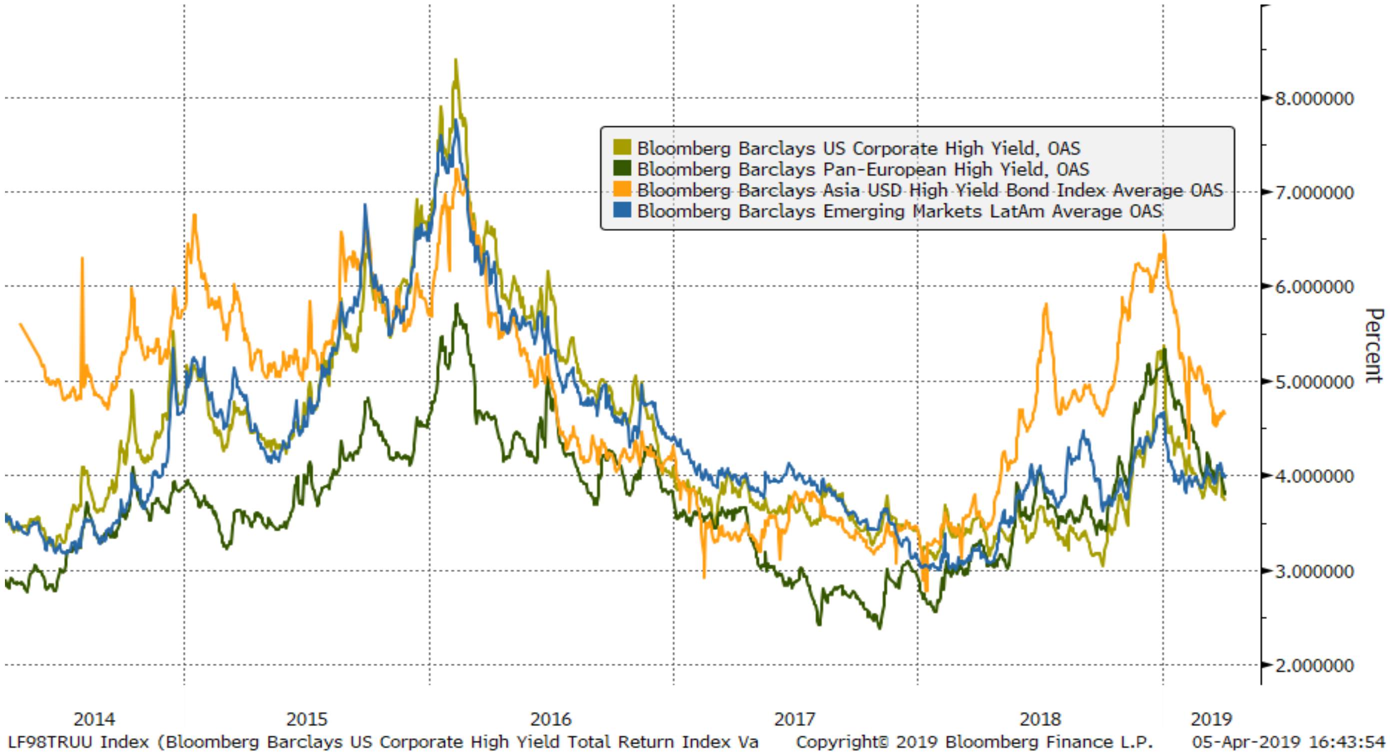
Corporate HY spreads have still room to tighten further

Assuming we have just a global slowdown, spreads look attractive and cloud even tighten



Asset Allocation

Overweight: Asia

Neutral: US and Latam

Underweight: Europe

- If you believe that yields will stay low for longer and that fiscal and monetary stimulus will prevent a recession, emerging market sovereign and corporate (HY) bonds do offer attractive coupons and return perspectives
- After last years Asian bond crisis we have increased our allocation over the last 6 months to Asian bonds and continue to prefer them over other regions

One last word of Warning

Howard Marks Co-founder of Oaktree about forecasting the credit cycle:

«You can’t predict it. You can prepare.»

Howard Marks: Mastering the Market Cycle: Getting the Odds on Your Side, 2018

Appendix

Supporting Charts

Financial Repression

Definition

Financial repression "played an important role in reducing debt-to-GDP ratios after World War II" by **keeping real interest rates for government debt below 1%** for two-thirds of the time between 1945 and 1980, the United States was able to "**inflate away" the large debt** (122% of GDP) left over from the Great Depression and World War II.[2] In the UK, government debt declined from 216% of GDP in 1945 to 138% ten years later in 1955.[9]

Source: https://en.wikipedia.org/wiki/Financial_repression

Investing in a time of financial repression

Conclusion from the Rothschild Wealth Management (2012) research paper

«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), restrictions on cross-border capital flows (to create a captive home market for bonds), new regulations for banks and insurance companies (to raise the amount of government debt they own) and interference in the management of pension funds' assets. More extreme forms of financial repression have included punitive taxes on buying and selling securities, the nationalisation of banks and bans on the private ownership of gold.

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 (inflation rates much higher than this tend to be very disruptive to economic and financial activity). Higher inflation makes interest rates negative in real terms, favouring debtors at the expense of creditors: while the nominal stock or face value of outstanding debt may be unchanged, its real value (i.e. its actual purchasing power) is steadily eroded. This liquidation effect can be quite substantial over time and acts as a tax levied on holders of domestic debt....

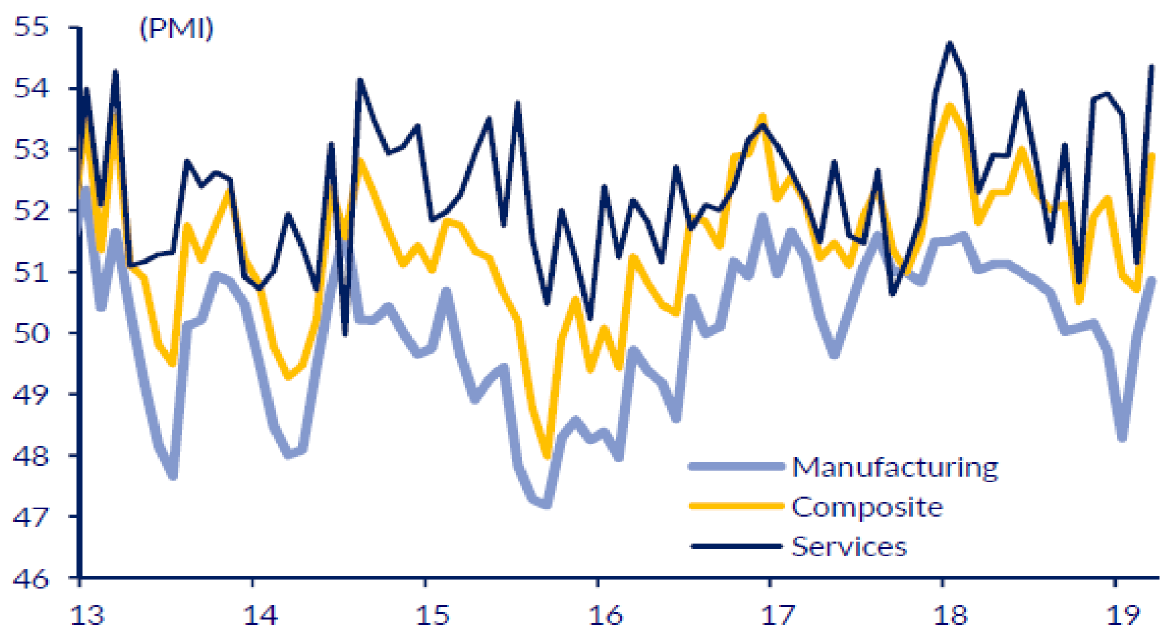
...The investment implications
In this environment, many investors will need to fundamentally rethink their investment strategies if they are to achieve returns that, at the very least, keep pace with inflation and preserve their purchasing power.

What can be done? As a first step, investors need to be prepared to embrace riskier assets, and to tolerate more short-term fluctuations in the value of their portfolios than they would have done before the financial crisis. For conservative investors more volatility is the price that has to be paid for maintaining positive real returns…»

China is recovering

All Chinese Markit PMIs are above 50 and are upward sloping!

Markit manufacturing, services and composite PMIs



Source: Markit

- At least Chinese purchasing managers believe that the fiscal stimulus will boost the economy.
- Most western analysts and strategists are still doubting

Contacts

Blackfort Capital AG · Freigutstrasse 8 · 8002 Zürich · Switzerland
Tel. +41 44 585 78 78 · Fax. +41 44 585 78 70 · info@blackfort.ch · www.blackfort.ch

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