

CQS INSIGHTS

Looking Into 2020

Sir Michael Hintze, Founder and Senior Investment Officer of CQS, presents his views on markets, risks and investment opportunities he sees in 2020.

The logo for CQS, featuring the letters 'C', 'Q', and 'S' in a stylized, serif font. The 'C' and 'S' are dark blue, while the 'Q' is a vibrant green. The letters are interconnected, with the 'Q' having a small tail that loops under the 'S'.

CQS

2019 has been a year of evolution for CQS. In January Xavier Rolet joined us as Chief Executive Officer, enabling me to focus on what I enjoy doing, investing.

For an asset management firm to prosper it must perform for its clients and provide them with the right investment solutions. To achieve this, requires operational excellence in investment, client engagement and operations. I am pleased to report that we have made good progress across these areas, further strengthening our infrastructure backbone, creating greater resilience and better decision-making through enhanced processes and cognitive diversity.

To preserve and grow capital for our clients is a responsibility we take seriously.

Sir Michael Hintze

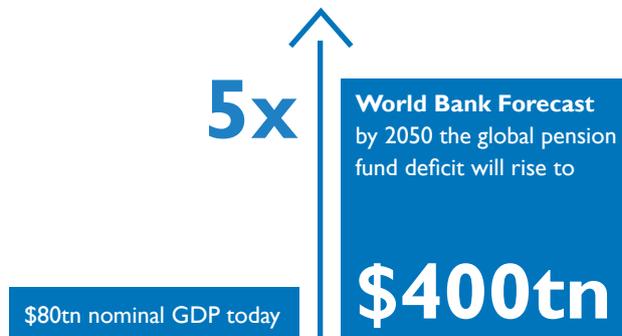
Founder and Senior
Investment Officer



The markets have grown in complexity and market structures have changed. This necessitates constant review of, and adapting to, an evolving market environment. During the year we have continued to bolster our investment talent and I believe we are more effectively utilising our absolute return DNA to deliver the returns clients expect from us.

We have further strengthened, broadened and deepened our investment capabilities to align more effectively resources with client mandates. We have made hires in research and portfolio management, developed our equities business, added adjacent skillsets to our Asia investment team and enhanced our geo-economic, macro and thematic research capabilities. Our journey to more effectively use technology across the platform and ensuring we have deeper ESG processes have also been important focuses.

The World Bank forecasts that by 2050 the global pension fund deficit will be \$400tn. That is five times today's \$80tn nominal GDP.¹ A major challenge for all investors is how to meet target returns in a low-to-negatively yielding environment. In this multi-dimensional world, I am convinced we will serve our clients more effectively through our global reach, helping them fill in the knowledge gaps through our insights, and leveraging our credit expertise across the capital structure in these complex markets. I believe this will enable us to deliver better returns to our clients globally.



Source: CIA Factbook December, 2019

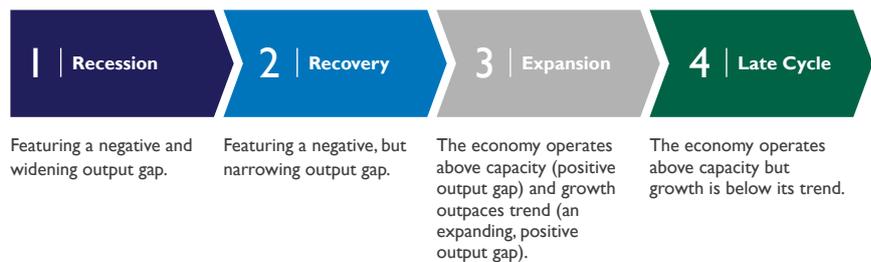
¹source: CIA Factbook December, 2019.

Market Views

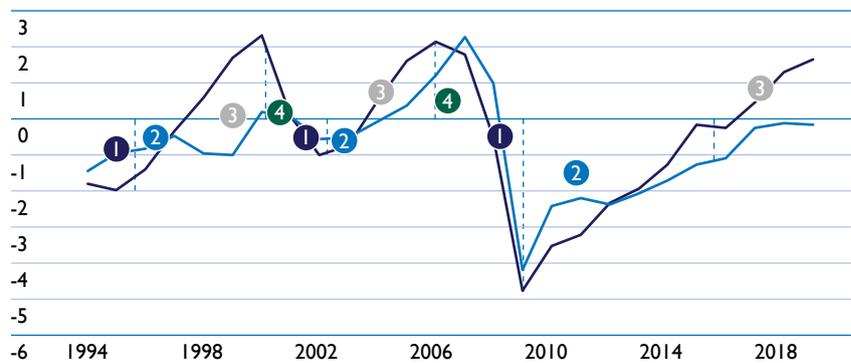
I am cautiously optimistic about 2020. There should be upside to growth in 2020 as monetary and fiscal stimulus kicks in — 20 of 33 OECD countries eased in 2019². The US economy is set to rebound over the next few quarters, China's GDP growth is stable, supported by monetary and fiscal stimulus, as well as market reforms, and there are signs the EU's economy has troughed and will see a tepid recovery. I believe global growth is intact, an imminent recession is unlikely and rates will remain lower for longer. This should be a supportive environment for markets.

After a significant slowdown in global growth in the past eighteen months, markets are increasingly concerned that the cycle is speeding towards its end. China continues to be an engine of growth for the global economy, but at the margin it is the US economy that will make the difference in the coming year. Figure 1 illustrates our thinking. Our deep dive into the US business cycle history and its phase transitions indicates that, at least for the coming couple of quarters, there is a high probability that the cycle stays in expansion mode. This is primarily due to low structural (trend growth), substantially eased financial conditions and low inflationary pressures for now.

Figure 1
At the margin, the US economy is the most important over the next 12 months



— US Output Gap
— G4 ex US Average



Source: CQS, IMF WEO (Oct 2019). Note: numbers in the chart indicate the phase of the cycle. Phase 1: Recession; Phase 2: Recovery; Phase 3: Expansion; Phase 4: Late cycle.

Empirically, this phase of the cycle sets a constructive base case for key assets: high-single-digit returns for equities, a moderate rise in US interest rates and a relatively flat yield curve. A maturing cycle should widen US credit spreads but, again, only moderately. Finally, it should help commodities and natural resources. This current phase is typically accompanied by an increase in short-term (predominantly equity) volatility.

²Source: CQS

Investment Opportunities and Portfolio Positioning

As some investors have repositioned away from high yield credit, we are finding opportunities created by this shift as it creates dislocations and mispricings.

There are exciting investment opportunities. There is dislocation, elevated dispersion, volatility and much idiosyncratic investment opportunity, both long and short. In the short-term, the reflation trade should be back on. A Phase One US-China trade deal should result in the restocking of supply chains. This would benefit markets such as South Korea, Germany and Japan. Japan's sensitivity to global trade, combined with corporate governance reforms and modest relative valuation, make it particularly interesting. In terms of sectors that we find attractive they include cyclicals and selected financials, as well as European banks which have been negatively impacted by negative rates or an inverted yield curve.

Investors increasingly ask about where we are in the credit cycle. While we are closer to the end than the beginning, I do not believe it is over. As some investors have repositioned away from high yield credit, we are finding opportunities created by this shift as it creates dislocations and mispricings.

As we head into 2020, I am mindful of rate risk. Tactically, I prefer high yield credit on a selective basis over investment grade. Given the elevated dispersion in US high yield as there is room for significant outperformance. In investment grade, I like BBB-rated cyclicals. Short-dated structured credit continues to be attractive. Sub-investment grade loans are beginning to offer significant value, especially given the technicals in that market (discussed in the loans section) and their floating rate attributes. In ABS, we favour Mezz CLOs and Regulatory Capital transactions. Credit relative value strategies look especially attractive given the dispersion we see. Special situations and distressed opportunities offer compelling opportunities over the coming year, especially in Europe. While default rates are presently modest (albeit rising), we are currently seeing and investing in many idiosyncratic situations.

Our teams cover differing assets classes in further detail later in my review.

Risks

With growing volatility, one needs to be mindful of the "potholes" out there, and there are many. It's important to keep powder dry, be nimble and size positions appropriately.

There are many risks and, as we have witnessed over the last few years, much geopolitically-inspired volatility. The list is long and includes *the rate of growth of the global economy; fiscal and monetary policy errors, QE/MMT, consumer confidence, market liquidity, Silicon unicorns under stress, Techlash, a huge and growing US budget deficit, climate change, US-China trade, Brexit and the EU, the Korean peninsula, Russia, Iran, populism and pandemics*. Each topic is complex.

Our geopolitical, geo-economic and macro team thinks deeply about each subject. We do need to understand the context to gain insight into its impact on markets and investment. I will focus on two topics that I believe will be at the fore in 2020, Populism and Modern Monetary Theory. Before doing so, let me make some observations about what we might see on the US-China trade negotiations. Our view is there will be a so-called Phase One deal in the near-term. However, talk of a Phase Two or Three deal is premature. Phase One could well mark the start of long-term strategic divergence. It is hard to see any grounds for compromise in areas such as technology, IP or structural reform in China. It is difficult to see meaningful progress before the US presidential election in November 2020, ahead of which President Trump will focus even more on his core voters. The ongoing strategic and geo-tech rivalry between the US and China will not go away, with Taiwan and Hong Kong potentially providing flash points for confrontation.

Populism is Here to Stay

It matters politically and can have economic consequences. “Why be a capitalist if you have no capital?” is one understandable driver. In many countries, a portion of the population, especially the young, do not feel invested in the economy. Government actions globally to prevent the financial system and economy from collapse post the Global Financial Crisis, resulted in massive quantitative easing (QE) and asset price appreciation. The massive provision of liquidity has benefitted asset owners and mortgaged future generations.

Something really important is happening. There are protests on the streets in many nations. A major rallying cry for the right is reaction to mass migration, while, most often, attacks from the left include protest against capitalism. Crudely-speaking, these movements typically appear to be anti-establishment, but more subtly they are challenging the very structure of society. They are all different, but share in common a deep dissatisfaction about inequitable distribution in society. The imbalance in the Gini coefficient is often present. There is a sense of injustice. There is deep-seated angst and a sense of unfairness. They also share common tactics, whether in Hong Kong, Spain, Chile, Ecuador, or the gilets jaunes (yellow jackets) in France. They are all based on an idea, they often appear leaderless and use social media to trigger flash demonstrations. They seek to influence public policy, and are often successful.

In some countries it has brought populists into government and in some countries to power. In every country it is shaping policy as the traditional parties and even autocratic leaders respond. New political parties have been established including the AfD in Germany and the Brexit Party in the UK; or reinvigorated old parties such as the Lega and Greens in Italy. Leaders who have come to power on a populist vote include Trump in the US, Orban in Hungary, the Freedom Party in Austria, AMLO in Mexico, Duterte in the Philippines and Bolsonaro in Brazil. US Presidential hopefuls Bernie Sanders and Elizabeth Warren’s support for the Green New Deal will be increasingly audible in 2020 ahead of the primaries as they seek to harness and echo this dissatisfaction. I also expect Green policies to become a focus of substantial fiscal expenditures in the EU.

Populism matters. It is driving politically-inspired market volatility, and therefore economic as well as political change. The most visible economic impact is an increase in government spending funded by a rise in government indebtedness and potentially higher taxation – note President Macron’s €10bn spending promise in reaction to the gilets jaunes protests. The causes are deep-seated, but the immediate reaction of governments is to spend their way out of it. Globally, there is a political imperative for growth. QE has been the primary tool of governments and central banks to promote stability and growth, but as QE’s effectiveness appears to be moderating, Modern Monetary Theory (MMT) is increasingly being talked about. Will governments and those aspiring to government be tempted to spend their way to happiness and power?

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MMT — a Perpetual Motion Machine?

The central tenet of MMT is that it is possible to use monetary policy – liquidity creation by a central bank – to finance large fiscal deficits, and create a “jobs guarantee” programme that strives to create employment and prosperity for everyone.

As a student of the market, let me share my observations from a market practitioners' point of view, as I am not a theoretical economist. In a QE-dominated environment, it seems to me something has changed. A Treasury can issue bonds to price insensitive buyers, more often a central bank or regulatory-driven buyer, through the banking system creating excess reserves. Hence the immediate effect is creation of liquidity in the banking system, not cash in circulation. There is some leakage, but this is absorbed by captive, price insensitive buyers like banks and insurance companies that have regulatory constraints, such as Solvency II, requiring them to purchase highly-rated paper. That said, central banks hope that cash will eventually make its way into the system. In an MMT world this process would intensify. This means there can be massive expansion of government balance sheets without immediate fear of it being inflationary.

The central tenet of MMT is that it is possible to use monetary policy – liquidity creation by a central bank – to finance large fiscal deficits, and create a “jobs guarantee” programme that strives to create employment and prosperity for everyone. There are some key theoretical gaps and inconsistencies behind the “theory” while the empirical precedents of MMT leave a lot to be desired; this is especially so when it comes to generating sustainable gains in real wages. For the immediate future, particularly with the current global political imperative for growth, there is support for MMT-type initiatives.

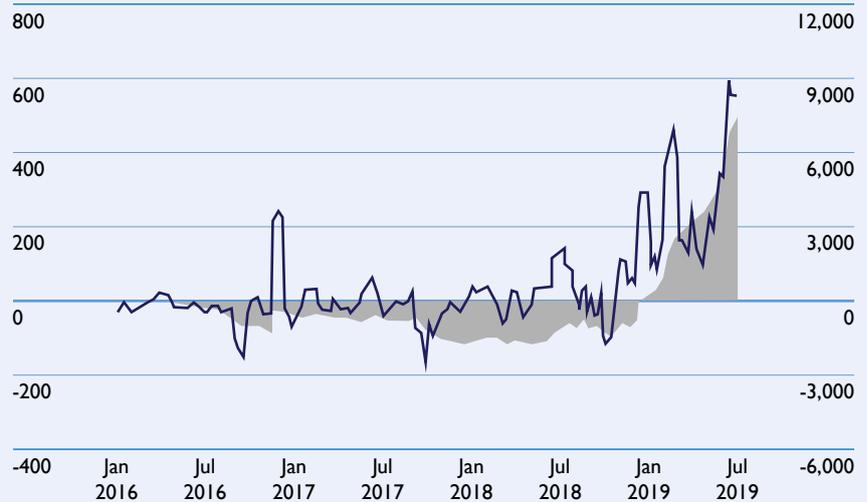
So what are the opportunities and risks? Monetary policy based on Keynesian theory in effect tries to address the so called “liquidity trap”. The effect of the indiscriminate use of Keynesian theory policy led to its failure. It was exacerbated by abandonment of the gold standard established by Bretton Woods, leading to a sharp rise in inflation. Keynesian economics led to the printing of money, stoking inflation. Paradoxically, MMT pushes rates down due to cheap, surplus liquidity resulting in the piercing of the zero band and negative rates. What will happen as the MMT perpetual motion machine is rolled out? How will it end? I suspect the currency markets will be the final arbiter. In a QE world, the fiat currency system is a faith system. The primary risk is a break in that faith, that belief. Amongst major global economies, Japan has been at the forefront of unconventional monetary policies and faith in the yen has not broken, but my sense is we are at the beginning of an experiment that we should watch carefully and be mindful of.

Thematics

Whilst there is much to do to optimize positioning and returns, to help make sense of portfolios, themes are important to look at. There are a number out there — geopolitical, geo-economic and macro, as well as themes including those well-trodden such as EVs, 5G and many other exciting developments. One major driver is ESG. Given the importance of the changes that are affecting our society, the way in which companies address and adapt to this new paradigm is creating valuation dispersion. This is a big deal.

Figure 2
Global money flow tracks ESG

■ Cumulative (RHS)
— Net Inflow 4WMA (LHS)



Source: EPFR. Compiled by Daiwa.

ESG...will increasingly affect valuations, cost of capital and performance.

It is clear to me that the growth of assets into ESG funds (see Figure 2 above), as well as a growing focus on ESG in investment will increasingly affect valuations, cost of capital and performance. Add to this, announcements such as the recent one from the European Investment Bank that it will end all lending to fossil fuels within two years, and one can see clearly the direction of travel.³ At CQS, we have embedded ESG into our fundamentally-driven investment process, as well as managing ESG accredited mandates.

³Source: <https://www.eib.org/en/press/all/2019-313-eu-bank-launches-ambitious-new-climate-strategy-and-energy-lending-policy>.

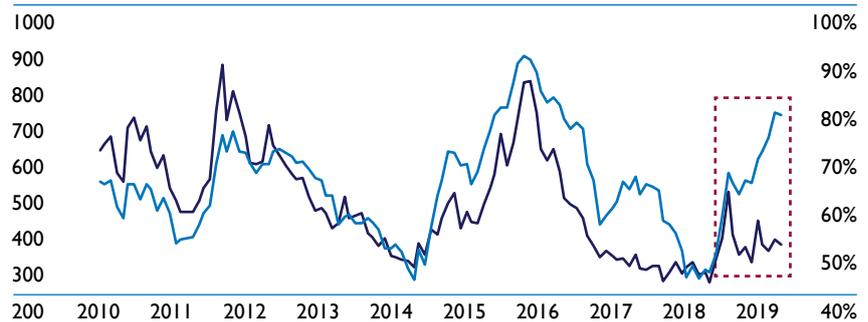
Asset Classes

High Yield

As I alluded to earlier, market valuations reflected the probability of a recessionary environment several times during 2019. Figure 3 illustrates the flight to quality in markets whereby during much of 2019 investors moved higher up in the capital structure while extending duration to benefit from the rally in rates. In part, due to this flight to quality, there has been more pronounced dispersion in high yield.

Figure 3
Dispersion in sub-investment
grade credit markets

— US HY Spread to Worst (bp) LHS
— US HY Dispersion (%) RHS



Source: CQS, ICE BofAML US High Yield Index (H0A0). Dispersion is measured as the percentage of names that are trading at more than +/- 100bps relative to the index.

This has produced a significant dislocation and material dispersion in the market and we believe a highly attractive opportunity for investors prepared to take a medium to longer-term view.

We continue to see compelling investments, both long and short. The key question for high yield in 2020 is whether the substantial spread dispersion between CCC and BB rated bonds will narrow. During 2019, concerns over economic growth led to a flight to quality, with investors moving higher up in the capital structure and extending duration to benefit from the rally in rates. These two components will drive high yield performance going forward. Our view is that there is upside to economic growth in 2020. We are positioning for underperformance in BBs potentially rates driven and unwinding of crowded positioning vs lower rated issuers in the more cyclical sectors, such as auto, manufacturing and industrial sectors. We also favour financials as they appear cheap versus corporate credit, especially ATIs in Italy, Spain and the UK where there are more favourable technicals given the limited supply expected. The sweet spot will continue to be idiosyncratic single B names, based on our fundamental analysis, taking advantage of that dispersion in US loans and global high yield.

While US high yield may appear optically cheaper, on balance we prefer EU high yield given the strong technical provided by the ECB's Corporate Sector Purchase Programme, which commenced in October 2019. US high yield is 15% energy. The growth in ESG and socially responsible considerations is affecting the sector's cost of capital. Private ownership may be increasingly attractive in the medium-to-long-term given the sector's cash flow characteristics and pressure on public market valuations, which may provide some interesting opportunities in the dislocation from the long side.

As high yield markets become more and more technically driven due to growing retail, ETF and passive investment strategies, the volatility should provide greater opportunities to exploit investments where spreads have far exceeded the fundamental probability of default of the investment. We believe it is only through active investment management that investors will outperform in high yield in 2020.

Credit RV

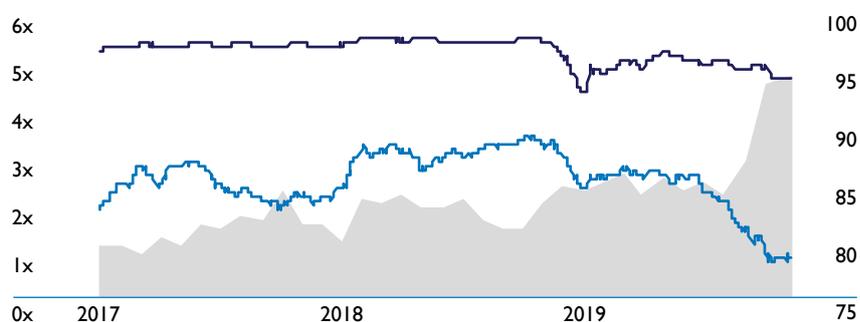
An environment of higher market volatility is typically accompanied by higher dispersion. We believe such market conditions exist and will likely persist. One of the best ways to express increased dispersion is through Relative Value strategies as pay-offs of volatility/dispersion can be highly asymmetric. In Europe, the ECB's QE activities include asset purchase programmes, which tend to favour IG corporate bonds. At the same time, growing dispersion means bifurcation between higher quality credits and lower quality ones, especially in high yield. For example, to 'own' dispersion, we might construct a highly convex, asymmetric pay-off by positioning long senior financial credit and short European high yield. Actual construction of such a strategy is far more complex but enables Relative Value strategies to own cheap convexity which benefits from increased dispersion.

Loans

The US loan market is experiencing both heightened sensitivity to a rise in defaults and a highly unusual technical situation. The number of downgrades relative to upgrades has increased sharply over a short period, as can be seen in Figure 4 below. Investor concerns around the late cycle environment, combined with rising US loan downgrades, has caused managers of collateralised loan obligation (CLO) vehicles to sell lower quality B rated securities in advance of potential further downgrades to CCC rating, which could result in CLO vehicles potentially being forced sellers at an undesirable time. This has left large dislocations in lower rated US loan prices, with many issuers being caught up in the technicals, despite having sound fundamentals. At the same time, in new issue markets companies are being penalised for their lower rating quality or having a cyclically-exposed business by having to pay higher coupons.

Figure 4
Downgrades/upgrades ratio at ten-year high

— Average B Loan Price (RHS)
— Average CCC Loan Price (RHS)
■ Downgrades/Upgrades Ratio (LHS)



Source: CQS research, and trailing 3month downgrades/upgrades ratio, LCD as at 30 September 2019.

Fundamental bottom up analysis can help investors identify loans that are misvalued relative to the probability of default and expected loss. We find oversold US Loans driven mainly by technical reasons versus purely fundamental, where the price more than compensates for the secondary market volatility.

Asset Backed Securities

Looking forward, we foresee banks shifting capital regulations and accounting standards driving an increasing breadth of issuers in this sector resulting in an increasingly attractive opportunity set.

We continue to find opportunities in structured products ranging from RMBS and CMBS to CLOs. In the CLO market, notably the spread basis between mezzanine CLO tranches and broader high-yield credit is at the widest level we have seen in some time. Persistent new issue supply has kept CLO spreads wide throughout 2019, and loan market volatility has added to dispersion in CLO manager performance. In particular, we believe current levels represent an attractive entry point for European CLOs, where, for example, mezzanine spreads have recently been at historically wide levels, due primarily to technical supply/demand considerations. This is reflected in the spread between EU CLO B tranches, which are still wide of 1000bp, while the ITraxx Crossover High Yield Index is at roughly 220bp.⁴ Crucial to this trade is security selection, which involves both assessment of the CLO manager and analysis of the CLO structure.

In RMBS, Agency Credit Risk-Transfer (CRT) tranches offer stable underlying fundamentals, good carry, and powerful roll-down as borrowers refinance their mortgages as rates fall. These profiles provide a stable and defensive return stream to our portfolios and remain some of the most liquid paper in ABS markets.

In CMBS we have begun to add selective legacy transactions that have US mall exposure. As the e-commerce retail disruption story continues to play out, we now are finding that market pricing has adjusted downward, and in many cases we can purchase paper which fully discounts potential losses from retail and mall closings. We are seeing early signs that mall operators are finding some success in repurposing anchor tenant space from big box retail into more service oriented productive occupancy.

The Regulatory Capital Relief sector is enjoying material new issuance in Q4 as banks look to optimise capital ratios prior to year-end and respond to the evolving regulatory framework. This increasing supply is being met with robust investor appetite as the appealing characteristics of this sector become more widely acknowledged.

Distressed

We believe today's distressed market is rich in opportunity.

Credit markets in 2019 have been a tale of two cities. High grade issuers have rallied meaningfully, while lower-quality corporates have come under a lot of pressure. This dispersion is the greatest since 2011. In many instances high-quality high yield has outperformed CCC buckets by more than 20% year-to-date.⁵ We believe today's distressed market is rich in opportunity. While default rates remain muted, debt-to-EBITDA for many levered issuers is approaching 6 times versus 6.2 times in 2007-9. There are also record adjustments to EBITDA and the number of cov-lite issuers has grown to an all-time record. While all these indicators do not necessarily signal stress, they do signal excess in terms of lending standards which typically precede distress. We believe the next down cycle will not be as severe as 2007 to 2009, but it will likely be broader-based.

While many investors focus on thematic when it comes to distressed investing – for example retail, oil and gas, telecoms, etc. – we believe it is individual companies within those sectors and geographies that provide value. Not every telecom company is created equal, not every retailer is created equal. While companies in a sector might struggle with the same industry undercurrents, idiosyncratic credit picking is about how a company is managed, invested (capex, etc.) and where a company sits in the value chain which ultimately determines whether it has a reason to exist.

When we think about late cycle investing, there are three things that we focus on to drive value. The first is event-driven investments, where there will be some type of M&A or a strategic buyer so that as a company goes through a restructuring process, there is a liquidity event on the other side. The second is investing in situations that are idiosyncratic and not related to the cycle. The third is identifying companies where even if there is a recession, it can be bought cheaply enough to trough EBITDA.

⁴Source: Bloomberg as at 2 December 2019. ⁵Source: Bloomberg as at 29 November 2019.

Conclusion

We have made good progress across our activities creating greater resilience and better decision-making through enhanced processes and cognitive diversity. We have strengthened, broadened and deepened our investment capabilities to more effectively align resources with client mandates.

I am cautiously optimistic about markets as there should be upside to growth in 2020. I believe global growth is intact, an imminent recession is unlikely and rates will remain lower for longer. This should be a supportive environment for markets. Fundamental analysis and security selection are key in this environment and active investment management should provide an edge as dispersion and opportunity grow. I am optimistic we can continue to generate good risk-adjusted returns for our clients in 2020.

I would like to thank our clients for their support. These are challenging markets and we have a huge obligation to manage client money. We take our responsibility to preserve and grow capital seriously. I would also like to extend my appreciation to our counterparties and, importantly, our staff for their hard work and dedication to serve our clients.

I wish you all the best for 2020.

Sir Michael Hintze

Founder and Senior Investment Officer

About CQS

CQS is a credit-focused multi-strategy asset manager founded by Sir Michael Hintze in 1999.

Our deep experience allows us to offer solutions for investors across a range of return objectives and risk appetites.

We are an active asset manager with expertise across the credit spectrum, including corporate credit, structured credit, asset backed securities, convertibles and loans.

We are committed to delivering performance and high levels of service to our investors.

CQS has offices in London, New York, Hong Kong and Sydney.

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PRI Note: PRI is an investor initiative in partnership with UNEP Finance and the UN Global Compact.

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