# CQS Insights

## Looking into 2018

**Sir Michael Hintze**

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CQS

**In this Q&A, Sir Michael Hintze, Chief Executive and Senior Investment Officer of CQS, presents an update on the risks and opportunities he sees in markets in 2018 and beyond.**

**Q** 2017 has been a pretty eventful year from an economic and geopolitical standpoint. Rates are higher in the US, yet many equity and credit markets globally have performed well thus far, and volatility has remained low. What has surprised you this year?

**A** I was constructive for markets as we headed into 2017, but I am surprised there wasn't greater volatility. There were certainly many events that could have created potholes whether concerns over diverging monetary policies globally, Quantitative Tightening (QT) or geopolitical events. I am also surprised by the markets' response to global growth; all 45 OECD economies are growing, with 33 accelerating.[1] Yet rates have stayed low.

**Q** You have been constructive for markets for some time. Is this still the case?

**A** For the medium-term, yes. The global economy is growing and corporate earnings with it. There are excess reserves in the financial system and I do not see inflation as a threat. That said, the market structure has changed. Regulation has reduced depth in certain segments of the markets, the popularity of passive over active investment management strategies, and systematic over fundamental styles creates vulnerability to short, sharp market moves. Shocks could well be exacerbated by model-driven 'autopilots'.

**Q** How are you positioning your portfolios?

**A** Notwithstanding my constructive view of markets in the medium-term. I have been more cautious over the short-term. Global growth is accelerating, rates could rise further than market expectations and there are geopolitical situations that add to a number of signals and market technicals that suggest to me potential potholes are out there. Consequently, I have added protection in the portfolios I manage. I have tried to be creative at the idiosyncratic-specific, index and geopolitical levels and bought protection to pick up convexity.

Given the end of Quantitative Easing (QE) in the US and moderation of QE in Europe, I believe it's going to be a credit pickers' market in 2018. During 2017, we began to see growing dispersion within indices. While volatility at the index level remained low, there have been rolling pockets of stress at the sector and issuer level, noticeably in the US. Looking through our global lens, we are finding value in Asia and Europe. With a rising rate backdrop, we continue to favour shorter duration and floating rate assets. Additionally given global growth, sectors such as commodities, cyclical and other names should perform well.

This is an exciting investment environment which plays to our global footprint and our analytical strengths as a fundamentally-driven, benchmark agnostic active investment manager. I am optimistic about our ability to find idiosyncratic opportunity and to generate returns for our investors.

Source: [1]OECD, Gavekal Research, 18 October 2017.

## Q You mentioned QT. Are you concerned about a return to a 'Taper Tantrum'?

**A** The short answer is yes, but the longer answer is more nuanced. A rates-induced correction is a possibility, however, my view is that there will continue to be sufficient liquidity in the overall system to be supportive of markets. While inflation will edge higher it will not be high. Figure 1 shows selected central bank purchases since 2008. QE has supported asset price growth including equity and credit markets.

There is an argument that as central banks begin QT asset prices will fall. I do not share this school of thought. Central banks are aware of the damage that could be done should Taper be aggressive. They will allow assets they hold to mature and roll off. I do not believe assets held by them will be sold. Furthermore, the Bank of Japan and the People's Bank of China are likely to continue to be accommodative. So the global monetary base is unlikely to materially decline. Figure 2 shows the US monetary base. The Fed's balance sheet expanded from around US$0.8tn in 2008 to US$4.3tn in 2014 and it now stands at US$3.8tn.[3] I expect the US monetary base to decline to below US$3tn over time, but excess reserves will be sufficient to be supportive of markets. As this takes place, there will be more dispersion of valuations and a return to greater market volatility. I am optimistic about the opportunity set this will present to us as an active manager.

**Figure1: Monthly US Federal Reserve, European Central Bank and Bank of Japan Asset Purchases[2]**

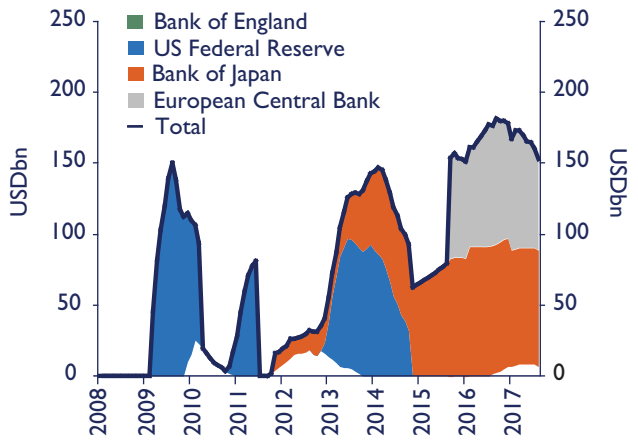
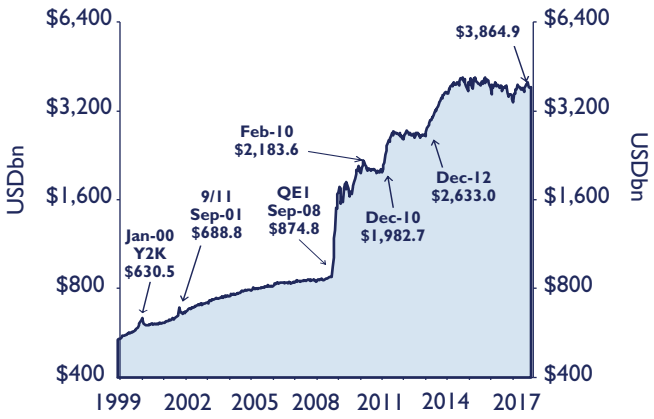



**Figure 2: US Monetary Base[3]**

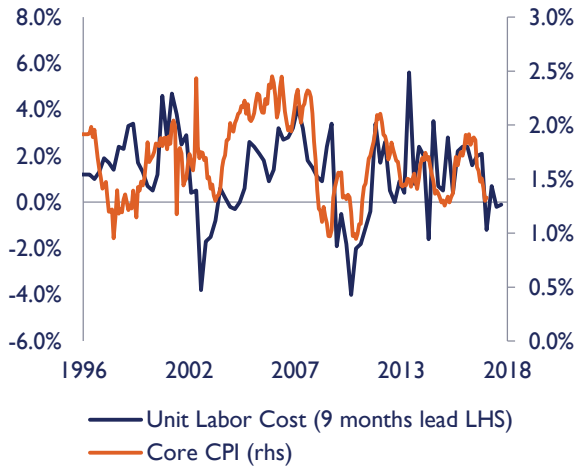
Bi-Weekly, Period: January 1999 to October 2017, Semi-log




## Q Why do you believe inflation will not be a problem?

**A** Inflation expectations must rise, but I don't believe we'll have runaway inflation. We are all familiar with the effect of technology and artificial intelligence on labour and this type of 'substitution' is happening throughout the global economy. It is clearly disinflationary. It is interesting to me that the US is close to full employment, yet, as you can see in Figure 3, unit labour costs are not growing much. While some rise is to be expected, I do not believe we are going back to the 1970s. Likewise, there is as yet little evidence of sustained producer price inflation.

**Figure 3: US Unit Labour Costs Still Moderate[4]**




Sources: [2]Deutsche Bank Research: US Outlook November 2017. ECB data is 6-month moving average, others are 12-month moving average. [3]Laffer Associates Economic Chartbook, October 2017 *Updated using the most currently available data. Monetary base (bi-weekly series) updated through to 25 October 2017; M1 data (weekly series) updated through to 16 October 2017. [4]Bloomberg, and CQS Research as at 29 September 2017.

There are of course exogenous factors to consider. Year-on-year, the oil price and commodity prices will be higher as we enter 2018, but again, I do not see substantial inflationary pressures. Another thing to consider is whether we are correctly measuring GDP and inflation. Are the baskets and their weightings genuinely representative of economic activity and inflation? This is a broader topic I am very interested in and we are presently looking into it in greater depth.

**Q** Many market commentators say that markets are richly valued, credit spreads are too tight and there's less opportunity to generate returns. What are your thoughts?

**A** I'm more optimistic than that. Fundamentals and technical factors are creating idiosyncratic opportunity. In High Yield it is all about dispersion, especially in the US. European High Yield is supported by an improving fundamental backdrop and some positive technicals, but with high single-name volatility.

While valuations are at the tighter end of historical levels, it's what lies beneath that matters – dispersion is back with a vengeance. Figure 4 shows that spreads typically tighten as rates rise and that spreads can remain low (and indeed lower than they are now) for extended periods of time.

But you need to look under the bonnet. Figure 5 illustrates the decoupling of Investment Grade and High Yield indices and, furthermore, growing dispersion within US High Yield credit versus dispersion in US Investment Grade. To some extent this is being driven by growing differentiation between faster-growing technology companies and traditional sectors. Technicals driven by allocations are also a factor. Money is flowing from individual names into indices and index-like surrogates that provide more liquidity. Consequently, there are growing allocations to both passive and index-tracking vehicles.

In Figure 6, one can clearly see dispersion is back within US High Yield.

**Figure 4: US High Yield Credit Spreads During Periods of Rising Interest Rates[5]**


**Figure 5: Decoupling of Investment Grade and High Yield is Ongoing[7]**

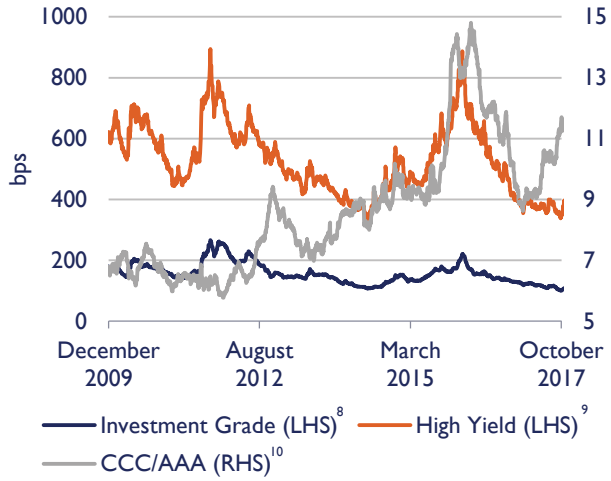
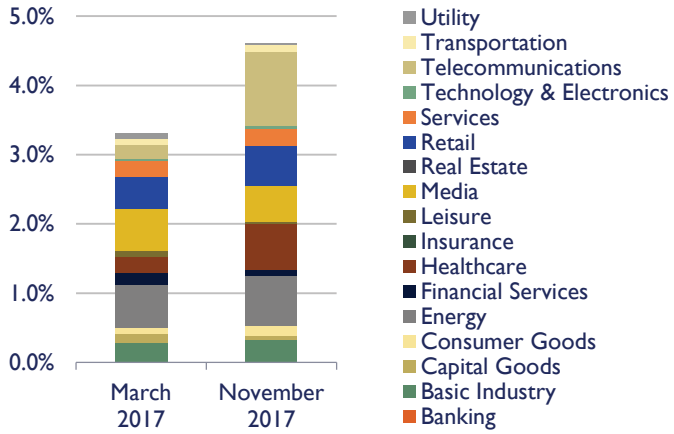


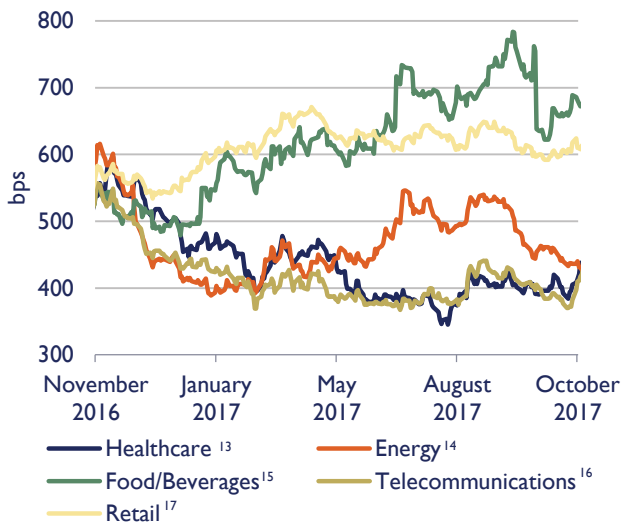

**Figure 6: High Yield Dispersion is Back[11]**




Sources: [5]Bloomberg and CQS research as at 31 October 2017. [6]ICE BofA Merrill Lynch US High Yield Index. (H0A0). [7]Bloomberg and CQS analysis as at 31 October 2017. [8]ICE BofA Merrill Lynch US Corporate Index (C0A0). [9]ICE BofA Merrill Lynch US High Yield Index. (H0A0). [10]ICE BofAML CCC & Lower US High Yield Index (H0A3). [11]Bloomberg, BofA Merrill Lynch and CQS Research as at 22 November 2017.

In the main, this has been driven by rolling pockets of stress in a number of sectors such as Oil & Gas, Retail, Telecomms and so on. US High Yield indices are heavily weighted to these sectors. Just look at what has been happening over the last few weeks following the abandonment of the T-Mobile merger with Sprint. There was contagion into the High Yield markets. Shortly thereafter, Altice reported quarterly results below market estimates and the contagion spread to the European High Yield market. If you had simply followed the indices, you would have missed out. We have been finding value and mispricings in issuers we like and based on our bottom-up fundamental analytical process. Active investment management is at an advantage when there is dispersion. Figure 7 provides a glimpse into what I believe will be more and more dispersion, differentiation and investment opportunity going forward. I am optimistic about our ability to find value and generate returns for investors in 2018.

**Figure 7: Dispersion in US High Yield is Back…With a Vengeance[12]**




## Q Can you provide more colour in other asset classes?

**A** The ABS sector is supported by positive fundamentals and technicals. Additionally, we believe there is a persistent complexity premium. ABS enables us to tailor risk/return profiles by selecting from a variety of geographies, asset types and subordination levels. We currently favour consumer-related exposures in the US and corporate exposures in Europe. We are positive on the CLO sector, particularly selected European CLO mezzanine and equity tranches.

In Senior Secured Loans, we presently favour the US, which should benefit from a continued positive technical environment with demand increasing as rates are expected to rise. Spreads over cash on single B's +350 to 400bps and double BBs of 275-325bps.[18] This is also a market environment in which convertibles should perform well. There should be further dispersion of outcomes for companies driven by the changing economic, fiscal and technological environment. This type of increased dispersion tends to play out well for convertibles given their asymmetric return profile whereby an investor can capture the upside participation while protecting the downside. Similarly, given lower volatility, we believe valuations are attractive.

Asia is also attractive and a heterogeneous market. Broadly-speaking, Asian economies are driven by China and Japan. Both these economies are growing. In the case of China, systemic fears around their economy have dissipated over the last 18 months as the government has managed to slowdown credit growth, while the recovery in commodity prices since early 2016 has helped the earnings of the material sectors, one of the weaker sectors in the Chinese economy. Furthermore, the continued growth in consumption and the diversification away from dependence on exports have allowed the Chinese government to slow capital outflows.

In Japan, the pick-up in global growth has stimulated exports and their exporters' corporate earnings. The Bank of Japan's monetary policy is also beginning to show results. Corporate Japan is not just beating earnings expectations but also increasing earnings forecasts.

Equity valuations are not overly demanding and multiples remain low by historical standards, with the trailing 12-month P/E ratio of Topix at 16 times.[19] Sectors we favour both from growth and valuation perspectives include automation and e-gaming. In Asian credit markets we continue to find ample idiosyncratic opportunities and convertibles are a good way to play our fundamentally positive view on Japanese equities.

Sources: [12]Bloomberg, BofA Merrill Lynch and CQS Research as at 31 October 2017. [13]ICE BofAML US High Yield Healthcare Index (H0HL). [14]ICE BofA Merrill Lynch US High Yield Energy Index (H0EN). [15]ICE BofAML US High Yield Food & Drug Retail Index (H0FR). [16]ICE BofAML US High Yield Telecommunications Index (H0TC). [17]ICE BofAML US High Yield Super Retail Index (H0SR). [18]LCD as at 22 November 2017. [19]Bloomberg and CQS analysis as at 20 November 2017.

**Q** Let's turn to geopolitics, which has been increasingly prominent among investor concerns over the past year. How do you assess geopolitical risk and its impact on the markets? What geopolitical events should we be concerned about in 2018?

**A** Geopolitical risk is poorly understood and often mispriced. Understanding the geopolitical context and the transmission mechanism from geopolitical events to the markets is critical. It's hard to trade geopolitical risk. It is often binary; it doesn't matter until it does matter. Looking into 2018 there are many 'known unknowns' out there, including potential conflict in North Korea, confrontations across the Middle East and challenges to stable government in Western democracies and to the US-centric global system.

**Q** You mentioned it is difficult to trade geopolitical risk. How do you use this context from a portfolio perspective?

**A** It sets a context for our portfolio managers on a number of levels. For example, our views on the oil price both in early 2015 and in early 2016 were in part driven by our assessment of the geopolitical situation in the Middle East. This informed our exposures to the energy complex and credit more broadly. Likewise, our view that China growth was not going to collapse and create a systemic fallout in early 2016 was also based on geo-economic insight and meant we had a positive view on natural resource names. It can also help us better understand and consider country-specific risk, informing us about timing and supporting our fundamental analysis in the pricing of risk. In my portfolios I also actively trade geopolitical risk.

**Q** Turning to the Middle East, you called the oil price correctly in both at the end of 2014 and in 2016. Saudi Arabia has been in the spotlight in recent weeks. What's your take on what is going on?

**A** In the short-term the oil price could have further upside and stay higher for longer. Nevertheless, I continue to believe the longer-term price of oil will remain in a US$40 to US$55 per barrel range, although spikes above and below this range are certainly possible for a period of time.

The Gulf Cooperation Council (GCC) region has seen enormous change in over the past few decades, but recent events in Saudi Arabia suggest a potentially massive game changer…and disrupter. We are tracking the Kingdom's Vision 2030, which has significant potential geopolitical and geo-economic implications. To be clear, success depends upon the young Crown Prince Mohamed bin Salman. His economic programme appears hugely ambitious but that shouldn't detract from what are sound aims such as economic diversification, weaning the Kingdom off oil and growing a vibrant private sector to generate wealth to create employment for its young population. It has been accompanied by a dramatic programme of domestic change vital to economic transformation; some of the measures that have been implemented were unthinkable just a few years ago.

This coming year is important to assess progress towards fiscal and other economic targets and whether it retains critical popular support, and also to see whether the campaign in bordering Yemen is brought to an end and good GCC relations restored. Saudi Arabia will be central to some of the great questions of 2018, like leadership of the Sunni world, the relationship between Sunni and Shia, and the relationship between Islam and the West. Saudi may no longer be the global OPEC swing producer of oil, but it remains a significant player in more ways than one.

**Q** And European populism?

**A** It is alive and well and directly impacting the EU's 6 biggest economies; it is not just about Brexit. The main themes for 2018 are in Germany, where Merkel is facing challenges forming a coalition which could affect EU Reform and Italy's forthcoming elections are the next major electoral hurdle. Despite Macron's stunning success in May's Presidential elections, over 40%[20] of French voted for the Far Left or Far Right in its first round. In the Netherlands, like in Austria, established parties veered to the right but Right Wing parties still made significant Parliamentary gains.

Source: [20]presidentielle2017.conseil-constitutionnel.fr.

During the German elections, the Centre Right FDP were revived and the Right Wing AfD made a significant breakthrough at the expense of both the ruling CDU and its SPD coalition partners. At the time of writing, Merkel is struggling to assemble the stable coalition in Berlin, which Macron and Junker and others need to underpin EU Reform.

In Spain, Madrid has called a snap regional election in Catalonia; if it backfires and the secessionists increase their majority, it could threaten Rajoy's minority government. However, Italy is the real worry, with an election looming in the spring. Just last year, Eurosceptic parties together were polling at 55%.[21] In recent months these parties have softened their position on referenda, but they are focused on reform.

As the recent Sicilian election showed, migration is the biggest political issue in Italy and Five Star are waiting in the wings ready to exploit the adverse impact of ESM decisions on Italy's banks. We need to keep a close eye on the growing stresses within the EU and Eurozone. I believe politically-inspired volatility is on the horizon.

## Q Looking at what are arguably more 'binary' events as you put it. What geopolitical disruptions are you most concerned about in 2018?

A 'Binary' is the right word in the case of North Korea. There are those who believe that conflict is inevitable. I am an optimist, and I hope it will not come to that; it would certainly be awful from a humanitarian standpoint. But let's hypothesise for a moment. If one were to conclude that the respective positions of North Korea and the Rest of the World on nuclear weapons are intractable and that risk is increasing, a trigger event may be inevitable (deliberate or not). The question is what type of conflict and how far it spreads. Is it conventional or nuclear? Is it contained on the Korean Peninsula or does it become regional or worse?

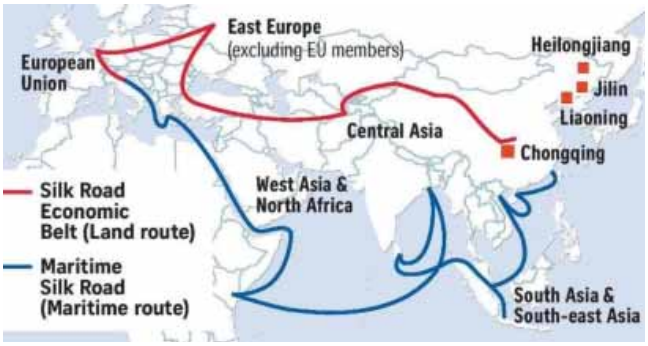
To provide a perspective, North Korea's population is estimated to be 25 million and GDP US$40bn[22] South Korea's is 38 million and its GDP is US$2tn.[22]

To place their economies in context, nominal global GDP is about US$78tn. China's GDP is US$12tn and Japan's US$5tn.[22] It is a significant concern and I hope the US and China are talking.

## Q On a more positive note, you have been a China bull for many years and visit the country often. Have your views changed since the 19th Communist Party Conference in October?

A China remains an engine for global growth. As expected, the Communist Party Conference enhanced Xi's authority. This is historic stuff. 'Xi thought' has joined that of Mao in the Constitution. And going forward? 'Socialism with Chinese Characteristics' means domestic governance may look less Western, but a focus on economic reform, environmental improvement and rule of law will create the conditions for entrepreneurial enterprise set out in the 13th Five Year Plan. China will be even more engaged in the world, as promised by Xi at Davos and emphasised by this year's BRICS and Belt & Road Initiative (BRI) events. Figure 8 illustrates the scope of China's ambition.

**Figure 8: China's One Belt, One Road Initiative[23]**




BRI alone means Chinese strategic engagement with over 65 states comprising about 65% of the world's population and one third of Global GDP[23] and including countries where the West appears unwilling or unable to engage. Xi has moved China far from Deng's 'hide and bide'; 'America First' might make it easier for him. Xi has much to do; beginning the process of addressing the challenges from China's shadow banking system

Sources: [21]www.scenaripolitici.com, as at 11 August 2017. [22]CIA World Factbook as at November 2017. [23]Bloomberg, Straits Times Graphics. [24]McKinsey 'China's One Belt, One Road: Will it reshape global trade?', as at July 2016.

should reduce concerns from a systemic, credit-induced threat for the time being. Looking forward, given current growth, commodities should be underpinned. The scale and character of Chinese activity is extraordinary. If successful, China may not just be set to dominate the region, but remould the world order.

## Q What are the biggest challenges for asset managers in 2018

A The industry challenges and trends continue to be similar to those I wrote about last year. Delivering risk-adjusted performance in line with a client's mandate is our core mission. This needs to be achieved in partnership with an investor and there must be an alignment of fees between investor and manager. Costs, primarily driven by regulation, continue to rise and industry-wide fee pressures are not abating. For the industry as a whole, finding cost efficiencies and scale will continue to be themes.

## Conclusion

In conclusion, there is global growth. Inflation should also remain relatively modest over the medium-term. I believe these factors will provide a supportive environment for markets in the medium-term, however, I am mindful of potential potholes in the shorter-term.

I believe our multi-asset approach to active investment management and our repeatable, fundamentally-driven investment process will deliver value to our investors.

I would like to thank our investors for their loyalty. I would also like to thank our counterparties for their continuing support and our staff for their hard work over the last year.

With best wishes for 2018.

Sir Michael Hintze, AM

# About the Author

**Sir Michael Hintze, AM, GCSG**
Sir Michael is the Founder, Chief Executive and Senior Investment Officer of CQS, a London-based credit-focused global multi-strategy asset manager. He is also a Senior Portfolio Manager.

Prior to establishing CQS in 1999, Michael held a number of senior roles at CSFB and Goldman Sachs. He began his career in finance in 1982 with Salomon Brothers, New York, after working as an Electrical Design Engineer in Australia, where he had also served as a Captain in the Australian army.

In 2014, Michael was called to serve on the International Advisory Panel for the Australian government's Financial Services Inquiry and subsequently as a Member of the Market Practitioners' Panel of the UK's Fair and Effective Markets Review. He presently serves as a Member of the Board of Superintendence of Instituto per le Opere di Religione (commonly known as the Vatican Bank) and sits on the Audit Committee of the Duchy of Cornwall. In the charitable sector, The Hintze Family Charitable Foundation has provided funding to over 200 charities mainly in the UK and Australia.

Michael is a fluent Russian speaker. He holds a BSc in Physics and Pure Mathematics and a BEng in Electrical Engineering both from the University of Sydney. He also holds an MSc in Acoustics from the University of New South Wales, an MBA from Harvard Business School and received a DBA (honoris) from the University of New South Wales.

# 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, Jersey and Sydney. Our investors include pension funds, superannuation funds, insurance companies, sovereign wealth funds, funds of funds and private banks.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