CQS Insights

Mid-Year Review 2017

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 2017 and beyond.

Q CQS had a good year across its platform last year. How have the first six months of 2017 been?

A From an investment standpoint it always seems challenging. Now is no different, if not more so. The end of QE in the US did result in greater dispersion, but in Europe that is yet to occur. Nevertheless, we are seeing opportunity on an idiosyncratic basis. Volatility as measured by the VIX index is close to its lows, however, when market 'shocks' occur, there is ample opportunity to take advantage of them. At those times, idiosyncratic volatility is high, but you have to be agile in your investment approach. The approach we take, in a world where implied and realised volatility is low, is to identify single-name opportunities via a multi-strategy approach that provides greater flexibility – this differentiates an active investment manager from a passive one. While we remain focused on our core capabilities in credit, we take a holistic approach to investment. We incorporate a broad range of inputs including economic policies, geopolitics and technological change which influence the investment landscape and help us to identify tail risks. Consequently, I believe active investment strategies will fare better going forward than they have over the last several years.

In the first half of this year we have delivered credible returns for our investors. Investors are central to everything we do and we increasingly partner with them by providing investment solutions across a range of return objectives and risk appetites in long-only, alternative and bespoke mandates.

The environment in which we are operating is challenging and the asset management industry is facing a paradigm shift. The trends in the industry environment that I described in my year-end 2016 *CQS Insights* are unchanged. There continue to be fee pressures, rising costs and industry consolidation. Nevertheless, I am confident our benchmark-agnostic, active multi-asset management style of investment will deliver value to our investors and enable us to grow.

We continue to invest in the business to ensure we deliver performance and high levels of service to our investors. We have broadened and deepened our footprint with a number of additions to the investment team. We are opportunistic when the right talent is available to enhance all areas of our business and we continue to invest in our people through training and education.

Q You have been cautioning about rising interest rates for some time. How do you see the global macroeconomic, geopolitical and market backdrop and what is your view regarding the direction of interest rates today?

A I believe they will edge higher. I am constructive both for equity and credit markets, notwithstanding that in aggregate they are at the richer end of the valuation spectrum. As always, I am mindful of 'potholes', however, I do not see any 'black holes' on the horizon. Nevertheless, we remain vigilant.

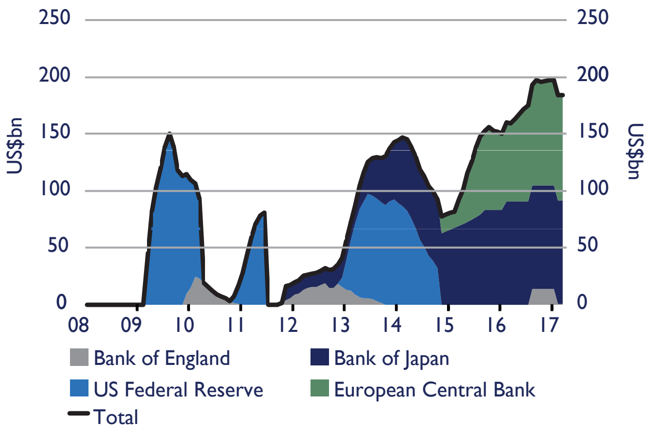
The global economy is estimated to expand by 3.6% in 2017 and 3.8% in 2018, with G10 economics growing 2% and 1.8%, respectively. EM economies are forecasted to grow by 4.7% in 2017 and 5% in 2018 driven by China, India and a re-bound in Brazil[1].

In the US, I believe interest rates must rise further and the US monetary base will shrink modestly over the next two years. Taper by the ECB began in April 2017. This is effectively a tightening of monetary conditions and I expect the ECB to adopt a more 'hawkish' stance and to halt asset purchases, potentially as early as Q4 2017. Both China and Japan will likely retain accommodative monetary policies, albeit credit conditions in China are in the midst of being tightened. As can be seen in

Source: [1]Morgan Stanley Global Macro Mid-Year Outlook. Transitioning to Self-Sustaining Growth June 24, 2017.

Figure 1, asset purchases by central banks worldwide are set to continue and the global monetary stock is likely to underpin markets. Fiscal stimulus is also set to expand with US infrastructure programmes and the continuation of China's ambitious 'Belt and Road Initiative', whose scope and ambition is not fully appreciated. Geopolitical events continue to have meaningful influences on markets, whether Trump, Brexit, North Korea and the Middle East, to name a few.

Figure 1: Central Bank Asset Purchases Supportive of Markets[2]



Another important aspect is currencies, which are always complex. They are a mixture of geopolitics, fundamentals, monetary policies and money flows. In a fiat currency world, the credibility of the central bank, coupled with how tight or accommodative a monetary policy is, makes a significant difference. The gorilla in the room is the US dollar. The only major theme I see is that Japan does want to weaken its currency for structural reasons.

Q What does this mean for how you are positioning portfolios?

A Recently, I have been adding to credit exposure and, in the short-to-medium term, we favour floating rate and short duration assets such as ABS, loans, convertibles and short-maturity structured credit. While many market participants continue to voice concerns about a 'credit bubble', I do not see any near-term catalysts that would result in a meaningful widening of credit spreads. Moderate global economic growth, combined with low default rates, is positive for credit and to me this is likely to remain intact for the time being, although I reassess this view frequently.

It is an exciting environment in which to find profitable investment opportunities and there are numerous longer-term themes, such as rising interest rates, which play to our strengths. One needs a holistic outlook and to think beyond markets to a broad range of inputs which influence the investment landscape. These include challenges surrounding operation of unconventional monetary policies, changes to the regulatory environment and disruption caused by geopolitical events and technological change.

Q You mentioned floating rate and short duration assets. Could you give more detail on how CQS' investment thesis is being implemented?

A For example, in ABS we find positive convexity to rate profiles in both RMBS and CLOs. US RMBS displays both positive fundamentals and technicals. In CLOs we favour European equity and mezzanine exposure over those from the US. We also find value in strategies driven by regulatory capital constraints, especially in the structured credit space. We have been working with European banks as they manage regulatory capital exposure to the corporate sector. As a key partner in this sector we have been able to extract complexity premia from such positions.

Elsewhere in the floating rate universe, we are also able to source attractive opportunities in the loans market. There are positive technical factors for loans which persist both in the US and Europe where demand continues to outstrip supply, providing support for secondary trading levels. Defaults are low, interest cover is good and the market for re-financings is open. We presently prefer US over European loans due to their all-in yield; US dollar Libor is presently 1.3%, Euribor -0.3%[3] with spreads for B and BB, in ranges of 375-425bps and 275-325[3]bps, respectively.

Convertibles are attractive due to the convexity of their return profiles. This is a good environment for this asset class. There is idiosyncratic opportunity, dispersion and corporate change. Equity volatility has been low which is creating strong opportunities to enter convertible arbitrage positions at attractive valuations. In long-only convertibles, we are focused on short duration assets which we think are well placed to benefit from the prevailing environment. We are overweight Europe versus the US and we have been adding to Japan.

Source: [2]DB Global Markets Research as at March 2017. Note: 12-month moving average. [3]LCD as at 23 June 2017.

In non-ABS structured credit, we have been adding risk in short maturity (typically less than two years) equity and mezzanine tranches. High yield is getting very interesting once again. As the oil price has recently weakened, we could see a mini-rerun of January and February 2016. The energy complex recently experienced heightened volatility and stress. This is fed into the US high yield market which has subsequently recovered somewhat, but it had little if any effect on European high yield. We are monitoring this space even more intensively.

In Asia, I am broadly positive as GDP growth remains robust. While the real estate market in China is slowing after a very strong 2016, the level of activity in construction is still strong. Flows into Chinese equities have recently been driven by its inclusion into the MSCI index. Away from China, economic trends in Japan continue to be positive, with real GDP forecasted to grow at an annualised rate of 1.5% in 2018[4] and the labour market trends are strong, suggesting continued economic expansion. Broadly-speaking, the region presents some attractive idiosyncratic opportunities ranging from certain equities in Japan and China, to convertible bonds in Japan and credit special situations in China, Japan and Indonesia.

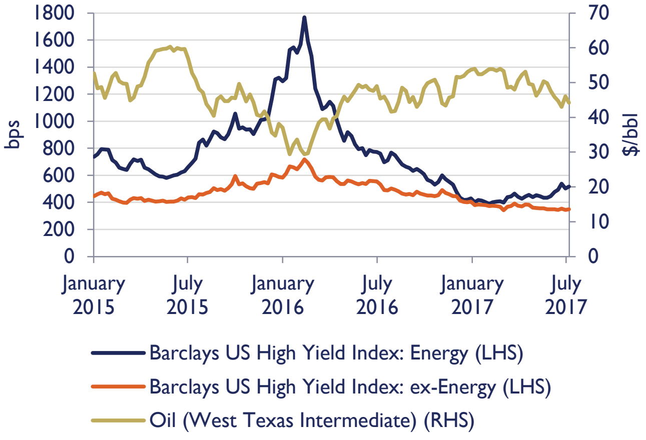
We have a team of analysts, traders and portfolio managers with the skills, experience and judgement to identify value in a given company's capital structure. Execution requires the use and understanding of sophisticated financial models in equity and credit. One needs to be mindful of the investment risk and also the operational risk of doing so in sophisticated markets. This enables a manager to express an investment thesis, price risk and to size positions appropriately. This is central to achieving strong, risk-adjusted returns for investors.

Q Since late 2014 you have held the view that oil prices will be locked in a longer-term $35 to $55 per barrel trading range. You mentioned the energy complex and suggested we could see a potential mini-rerun of the volatility experienced in January and February 2016. Can you elaborate on this?

A That's right. My view regarding the $35 to $55 per barrel range remains. It is based on our analysis of cost curves and our belief that the US is now the global swing producer of oil. The reason for this is that a meaningful quantity of US shale production can be brought to market in a relatively short period of time. Furthermore, the ability of many OPEC and non-OPEC producers to cut oil prices for a longer period of time is limited by their high fiscal needs, especially the Kingdom of Saudi Arabia and Russia. Our reading of the cost curve suggests a price below $35 to $40 would not be able to meet that demand, given there is approximately 95 million barrels of daily world demand for oil.[5] That said, it is a commodity market and a spike below $35 is always possible, but not sustainable. For a more detailed analysis, take a look at our CQS Strategy Perspectives: Is this the End of OPEC?, published in January 2015 and a follow-up piece from February 2016 CQS Strategy Perspectives: The Middle East: Growing Complexity and Rising Geopolitical Risk.

The US high yield market has a number of interesting dynamics. There is significant demand from the ETF market, driven by an indiscriminate search for yield, mainly by retail investors. However, that doesn't mean there is an absence of value. The oil price does drive long-term returns in the energy sector and the energy complex has been under growing pressure since March, with some credits down 30 to 40 points from this year's highs. Figure 2 illustrates the spread of selected US high yield indices and the oil price.

Figure 2: US High Yield Energy and US High Yield ex-Energy vs. Oil (WTI)[6]



The US high yield energy index has widened from 420bps to 500bps. This is the process by which opportunity is generated. Given our view on the oil price, I think it is premature to seize the energy opportunity.

Furthermore, underwriting standards have loosened which potentially makes credit more risky, but also provides an opportunity for those managers with the ability to do the deep-dive analysis.

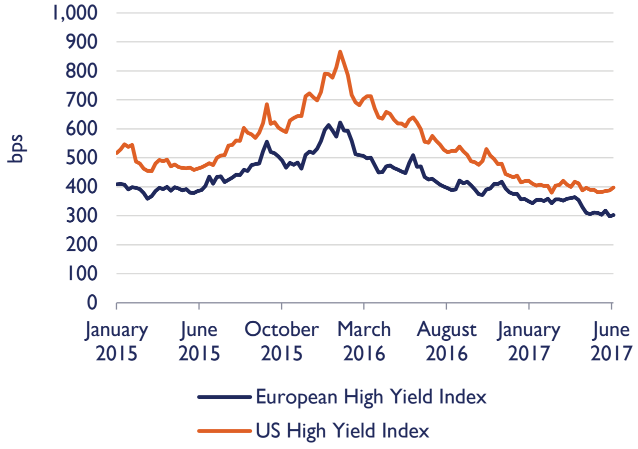
Source: [4]Morgan Stanley Global Macro Mid-Year Outlook. Transitioning to Self-Sustaining Growth 24 June 2017. [5]IEA Oil Market Report 14 June 2017. https://www.iea.org/oilmarketreport/omrpublic. [6]Bloomberg as at 5 July 2017. Barclays US High Yield Index (Energy Only) is BHYEOAS Index. Barclays US High Yield Index: ex-Energy is BHYXOAS Index.

Q What about the rest of the US high yield market and what about European high yield credit?

A Energy comprises around 13% of the US high yield market[7]. The rest of the US high yield market has performed relatively well, aside from certain specific segments such as retail. However, if the oil price were to spike below $40 per barrel I could see a contagion developing into higher quality performing energy names in the US, followed by the broader US high yield market and potentially into investment grade. Based on our fundamental views, we would be looking to add to, or initiate, positions in specific names on any such weakness.

As is illustrated in Figure 3, Europe has been buoyant in comparison with the US, supported by ECB purchases and improving fundamentals.

Figure 3: European High Yield vs US High Yield[8]



We have been cautious about the European high yield market for some time, given how tight spreads are. However, there is opportunity if one focuses on a fundamentally-driven, idiosyncratic investment approach. Of late, we have targeted four types of sub-strategies:

Refinancing Strategies
These are typically stronger corporate credits that are out of favour. We have been investing in the deeply subordinated parts of capital structures with short duration, which we believe can be refinanced in the short-term.

Single-name Volatility Strategies
These are typically companies which have had a disappointing earnings result and whose credits have widened out more than we believe is justified, based on our analysis and view of the price of that risk.

Financials
In this area we seek to harvest illiquidity and complexity premia in financials, mainly in the lower tier BB financials where deep dive analysis gives you an edge.

Special Situations
This can include picking up cheap volatility in names where we have a strong fundamental view, as well as sectors, such as shipping, which we presently like due to a combination of a pick-up in world trade, lower energy costs and a sharp decline in forward capacity.

One needs to work hard to find value and I am confident we can continue to do so.

Q Investors often ask about liquidity. Is a lack of liquidity still prevalent? Do you believe the Trump administration's proposals to reform Dodd-Frank will bring back market liquidity?

A Liquidity is a much more nuanced topic and it is a mixed picture. The most important aspect is to match asset and liability durations. Liquidity in major market indices, whether equity or credit, is sufficient. Liquidity for single names can vary materially. That said, it is possible to execute in good size if one is patient. Equity market liquidity is still relatively high, but I sense there is interference from high frequency and algorithmic trading. It is potentially more difficult to execute a block trade. This structural change was in part driven by Dodd-Frank and in part it is a function of regulatory risk weightings relating to Basel III, and I sense it will not return to its former state.

This has led to bouts of mark-to-market volatility which needs to be thought through carefully. At times, this leads to a material widening of liquidity premia which can be captured. The lack of market volatility has made certain asset classes such as private equity and peer-to-peer lending more attractive to investors. But in terms of public markets, if capital is patient, flexible and nimble, there is value to be captured.

There are two studies of note. The first, by JP Morgan, is focused on equity markets. It cited an analysis of market depth pointing out that in 2012 it took 7,000 to 9,000 futures contracts to move the S&P future by one point, whereas by 2017 that had fallen to 4,000 to 5,000[9].

Source: [7]CQS analysis 5 July, based on the Bloomberg Barclays US HY index MV vs. Bloomberg Barclays US HY Energy sub index MV. [8]Bloomberg as at 5 July 2017. European High Yield Index is BofA Merrill Lynch Euro High Yield Index (HE00). US High Yield Index is BofA Merrill Lynch US High Yield Index (H0A0). [9]JP Morgan, as at 11 July 2017.

The second, by the New York Fed, focuses on the corporate bond market. It concludes liquidity for institutional investors has not changed materially over the last several years, although levels are lower than in the immediate lead up to the global financial crisis. There continues to be diminished market liquidity in certain parts of the fixed income market. Dealer balance sheets have contracted sharply from around $5 trillion in 2008 to $3 trillion at the end of 2016 and Treasury depth is below all-time highs.[10]

I believe that it is fundamental "bottom up" credit and equity analysis that helps you distinguish real value, and that appropriate sizing of positions and matching asset and liability durations enables you to weather most crises. Overall, this should make assets more attractive, providing one can source and hold the assets through volatile markets. Patient and flexible capital should be best able to benefit from this volatility.

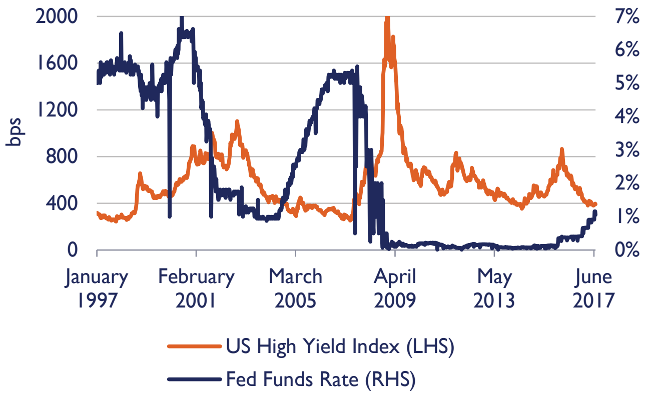
Q There has been growing concern about a credit bubble over the last few years. What are your thoughts?

A History suggests there will always be booms and busts. I have been a market practitioner for over thirty years. My experience has taught me to frequently re-evaluate my assumptions and to act in a timely and decisive fashion, especially if a view is proving incorrect. While in aggregate credit markets are at the richer end of the valuation spectrum, at this time I cannot see any black holes; potholes yes, but black holes no. Underlying economies, especially in the US and Europe, are supportive of credit markets, QE has pushed out the benign default environment and maturities have been extended. While credit spreads are towards the tighter end of historical ranges, they are not at their lows and there is sufficient dispersion and idiosyncratic opportunity.

History shows us that periods such as the one in which we find ourselves presently are not unprecedented, and that low credit spreads have endured for months, if not years, absent any visible catalysts, and even during periods of central bank tightening. The difference today is that the risk-free rate is low in the US and negative in the EU. This underlines our view that there is a risk to the risk-free rate and portfolios should be positioned in floating rate and short duration securities.

Figure 4 illustrates how US credit spreads have moved during periods of rising interest rates since 1997. Similar spreads to those today were evident during the first nine months of 2014, between May 2004 and July 2007, as well as during 1996 through to August of 1998. The low points for US high yield spreads were in April 1998 and January 2007 – both around 265bps versus 391bps presently and all -in yields at approximately 7.5% and 8.5%, respectively, versus 5.5% now.

Figure 4: US High Yield Credit Spreads During Periods of Rising Interest Rates[11]



The situation in Europe is similar, with euro high yield spreads in the period from mid-2004 to April 2005, and mid-2006 to mid-2007 having been at similar levels to those of today. Interestingly, credit spreads were below 250bps for much of the 2005-2007 period and as tight as 183bps in May 2007. As with the US, it is the all-in yield that is lower now.

Supply/demand dynamics continue to be generally supportive of US high yield markets, and the ECB's asset purchase programme is still supportive of EU corporate credit.

Looking more closely at corporates' financials, cash flows continue to improve in US and EU high yield credit. Aggregate metrics covering revenue growth rates, EBITDAR growth rates, free cash flow-to-net debt are supportive of current valuations. Importantly, these measures are averages and there is sufficient dispersion around the averages. In the US, there have been rolling pockets of stress, distress and dislocation in a number of sectors including retail, energy and financials. There is idiosyncratic opportunity.

Source: [10]Federal Reserve Bank of New York, Market Liquidity after the Financial Crisis, June 28, 2017. http://libertystreeteconomics.newyorkfed.org/2017/06/market-liquidity-after-the-financial-crisis.html]. [11]Bloomberg as at 3 July 2017. US High Yield Index is BofA Merrill Lynch US High Yield Index (H0A0). Fed Funds Effective Rate is the ICAP Fed Funds Rate.

Presently, we are watching carefully developments in a number of sectors including the energy complex.

There are of course countless things that could 'go wrong' including:

- Serious China slow-down would be a shock to the world;
- A sharp loss of consumer confidence and consequent decline in economic activity
- Higher default rates
- Stagflation
- Geopolitical shocks, especially North Korea or oil;
- A loss of confidence in central bankers, and
- A liquidity-inspired decline in asset prices due to ETFs.

This is not an exhaustive list and we are vigilant. We are living in a complex world which underlines my view that a holistic view of risk factors is important to gaining market insight.

Q There have been concerns about rising risks in Chinese local government debt and more broadly Chinese credit. What are your perspectives?

A Let's take a step back. It is important to place context around the answer to this question. The Belt and Road Initiative (BRI) is underappreciated in its ambition. It is a turbo-charged 21st century Silk Road that plans to create connectivity and cooperation across Eurasia. The cumulative investment is reported to be between $4 and $8 trillion[12] to build commercial, manufacturing and transportation links from Eastern Russia, across Eurasia, Australia and Western Europe. It is consistent with how China sees its place in the world and reflects the country's expanding interests on the global scene. The BRI will also be supportive of China's intention to establish the yuan as a reserve currency, supportive of global trade and enable China to continue to expand its presence on the world stage.

BRI is an underappreciated fiscal stimulus to growth in China and the surrounding economic region that can mitigate tightening within China due to slower credit creation. The short answer to the initial question is that I am not worried, but clearly, the rate of credit expansion in China needs to be watched and, as I mentioned earlier, credit conditions in China are being tightened. The banking picture in China could be troublesome as the balance sheets of some major banks appear stretched and default rates are rising. Property developers' credit is coming under scrutiny and Chinese Regulators are looking at those companies which have been deeply involved in foreign acquisitions and the impact this is having on their balance sheets. However, one could argue that state-owned bank exposures to state-owned enterprises are in effect owned by the same central hand and would negate one another. Capital flight has been a focal point of Chinese policy makers and it is being addressed. The private sector of the economy is vibrant and growing. So while I believe one needs to be vigilant, overall, I am constructive.

I have visited China regularly over many years. During such visits, I have had conversations with senior Chinese leaders and it is clear to me that they have a vision and understand the challenges. The leadership is smart and I believe they will be able to navigate issues associated with their long-term planning. We will know more detail as the November Communist Party of China National Congress (CPC) nears. It is also worthwhile reflecting on their ability to implement long-term policies – in effect they have a ten-year electoral cycle which compares to what is in effect a two-year electoral cycle in the US.

Q What about other geopolitical risks and what events are you particularly monitoring for the second half of the year?

A It is an increasingly complex world. In the last year while extraordinary geopolitical events have raised profound questions and threatened political stability, they have been largely ignored by the market. A succession of European elections saw the emergence of populist movements but the greatest surprises were in June when President Macron shattered the French political establishment and the UK returned to 'Two Party' politics with a severely weakened government just in time to commence Brexit negotiations. In the Middle East, a number of the GCC states, surrounded by the chaos of Yemen, Syria and Iraq, have turned on each other, imposing diplomatic and economic sanctions on Qatar which threaten the cohesion

Source: [12] https://en.wikipedia.org/wiki/Belt_and_Road_Initiative.

of the Sunni allies and expose the limitations of US foreign policy. Meanwhile in Washington, US President Trump and the US Republicans failed again to get a healthcare package approved, increasing the list of delayed action items for the US administration. None of these have affected markets, yet; but with each layer of complexity comes fragility which could in time have significant implications.

Q What geopolitical drivers are you monitoring during this second half of 2017?

A I think rumours of the demise of populism are premature, and that it may resurface in emerging markets such as South Africa and Turkey, or where leaders such as Macron seek to implement vital and long overdue reforms. Mediterranean migration, a dreadful humanitarian crisis, is also a toxic political problem and may be a major driver of the behaviour of electorates and governments across Europe in the months ahead, not least in Italy. The Qatar problem is a concern which hopefully will not distract the GCC states, especially Saudi Arabia, from the urgent business of weaning their economies from oil dependency and ambitious programmes of national transformation now underway. China appears well-placed to continue to expand into any vacuum left by an increasingly isolationist US in South East Asia, and in its Belt and Road Initiative (BRI), while perhaps more political than economic, is just too big to ignore. But US-Chinese co-operation seems critical to tackling the problem that is nuclear North Korea, even as President Xi positions himself ahead of this year's CPC in late-October. In the US, the debt ceiling must be addressed by mid-October, when the US government runs out of cash, in addition to healthcare reform, tax reform and Invest in American Infrastructure, to name a few. Moreover, the Republicans and Trump administration face a shortening period of time in the Senate's legislative calendar before year end, which will make it a difficult time for the Trump presidency. And I haven't even mentioned Brexit!

The key, as always, is achieving an understanding of the geopolitical context, and identifying trends and potential transmission mechanisms into the global economy and markets.

Conclusion

I am constructive for equity and credit markets. I believe interest rates must rise. While markets are towards the upper end of their valuation ranges, there is dispersion and idiosyncratic opportunity in corporate credit that plays to our fundamentally-driven investment approach. I believe our multi-asset, benchmark-agnostic active style of investment management will deliver value to our investors. It is an exciting time to be in the investment management business.

Thank you.

Sir Michael Hintze
CQS Chief Executive and Senior Investment Officer

About the Author

Sir Michael Hintze
Sir Michael is the Founder, Chief Executive and Senior Investment Officer of CQS, one of Europe's leading credit-focused multi-strategy asset management firms. 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 for Civil and Civic Pty Ltd in Australia, where he had also served in the Australian Regular Army in the Royal Australian Electrical and Mechanical Engineers, latterly as a Captain.

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 Vatican Bank Board and sits on the Audit Committee of the Duchy of Cornwall.

Michael has significant and wide-ranging philanthropic interests and to consolidate these, the Hintze Family Charitable Foundation was established in 2005. Since inception, over 200 charities have received funding from the Foundation.

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, insurance companies, sovereign wealth funds, funds of funds and private banks.

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