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INVESTMENT MANAGEMENT

Calm Before the Storm

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“They sicken of the calm, who knew the storm.”

— Dorothy Parker

AUTHOR

ANDREW HARMSTONE

Managing Director

Andrew is lead portfolio manager for the Global Balanced Risk Control Strategy (GBaR). He joined Morgan Stanley in 2008 and has 36 years of industry experience.

Hurricanes form off the coast of the United States every year. Many never make landfall, but as this hurricane season has shown—already the most expensive on record, with a preliminary damage estimate of $184 billion[1]—they can be devastating. We see a parallel dynamic in the global economy: A number of storm fronts are forming off the coast of what is otherwise a calm environment.

First, the good news: The world’s major economies have been logging steady growth in the single digits, and Purchasing Managers’ Indices – widely viewed as leading indicators of business conditions – are above the critical level of 50 for most regions, indicative of likely economic expansion (*Display 1*).

But there are a number of potential risks on the horizon. Last month, we discussed the North Korean standoff. Here we examine other possible threats to our otherwise positive outlook.

Interest rates: Watch out for an upward spiral

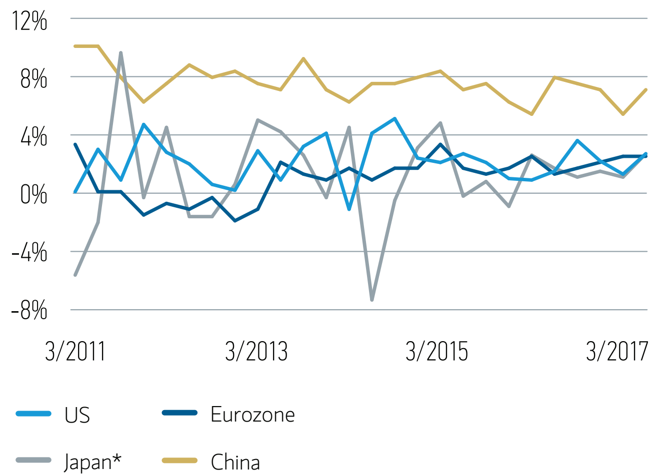
The coming normalisation of interest rates is something for which investors should prepare. Rates are still low, and the precise timing of rate increases remains uncertain. Yet we are starting to see strong evidence of upward pressure on interest rates.

[1] https://en.wikipedia.org/wiki/List_of_costliest_Atlantic_hurricanes

DISPLAY 1

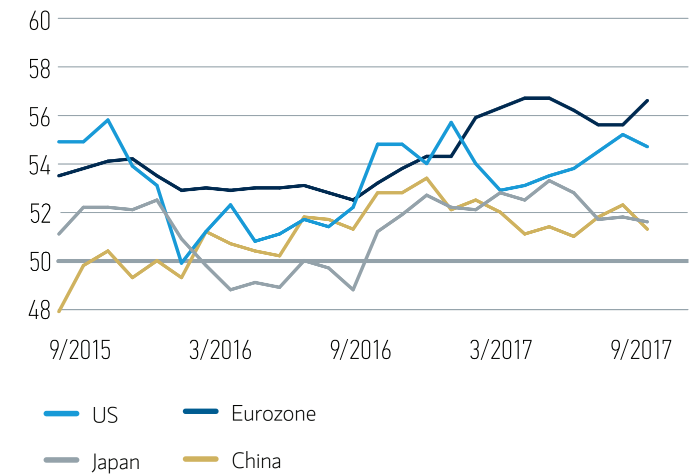
Economic growth rates have normalised . . .

QoQ annualised GDP growth



. . . and key indicators are healthy

Markit Composite PMI



Source: GDP Growth Source: Bloomberg, data as of 30 June, 2017; * Source: Econoday, Japan Q2 2017 GDP based on market consensus. PMI (Purchasing Managers Index) data as of 30 September, 2017.

Quantitative easing (QE) in recent years has, by reducing interest rates, fuelled corporate demand for debt. Since corporate debt trades at a spread to Treasuries, lowering the overall level of interest rates also lowered the cost of corporate debt. This was intended to encourage companies to borrow and invest the proceeds in productive capital equipment that would drive profitability. They did their share of borrowing, but instead of investing productively they used vast amounts of the proceeds to repurchase their own shares (*Display 2*).

Possible "one-two" punch for equities

The buybacks served as a significant pillar of support for stock prices, but unfortunately drove corporate debt-to-revenue ratios higher. As a result, companies' capacity to take on additional debt has diminished just as we are starting to see the surge in investment that central banks sought. Against a healthy global economic backdrop, capital investments are now looking attractive and companies are finally starting to invest in earnest in productive assets—but they are doing so just as interest rates are rising. The timing is going to cost them.

We believe this capital investment is necessary and will eventually lead to improved productivity, but it has to be financed. With already high debt-to-capital ratios and climbing interest rates, corporations may need to fund their investments by issuing stock. Two dynamics – the depressing effect of higher borrowing costs on earnings and the issuance of new equity – are likely to be set in motion. Taken together, they have the potential to pose downside risk to equities.

Government debt: A problem of global proportions

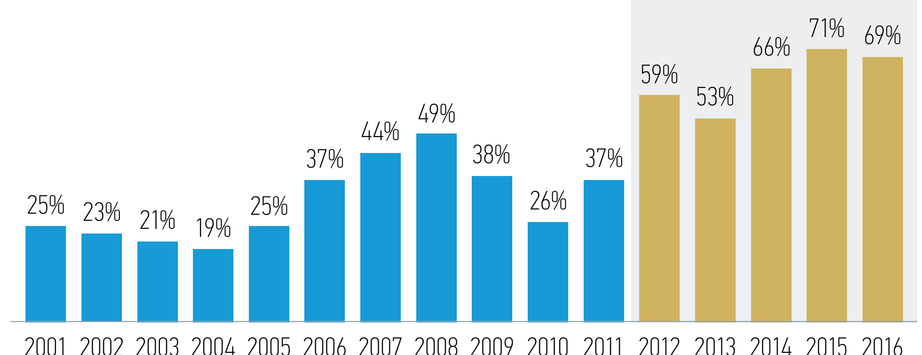
Corporations are not the only ones that will suffer from higher interest rates. Major central banks around the world – including the U.S., China, Europe and Japan – sharply increased their debt levels over the past decade. Higher interest payments would have the

DISPLAY 2

Recent borrowings: Less supportive of productivity

From 2000-2011
Less than half of corporate borrowings were used for stock buybacks, leaving room for productive investments.

Last five-years
Companies have borrowed vast amounts to buy back stock – instead of investing in productive assets



Source: Bloomberg as of 16 September 2017.

potential to damage budgets and cause deficits to balloon, which could lead to more contractionary fiscal policies than people envision at this point. The U.S. Congress and president are discussing tax cuts, but with the looming prospect of rising interest payments, they may find themselves in a position where they have to revert to tax increases. Consumers would also suffer from higher interest rates, particularly in the U.S. and the UK, where household debt is relatively high (*Display 3*).

Although the Fed has already indicated that it intends to raise rates and shrink its balance sheet, the market continues to disbelieve it. Comparing the Fed funds rate with the futures market shows a big gap: Fed officials are expecting one more hike this year and three in 2018, yet the market is pricing in only one to two hikes in 2018—either the Fed or the market is wrong. Given the underlying strength in the global economy and pickup in business investment, it could be that this time the market is misjudging.

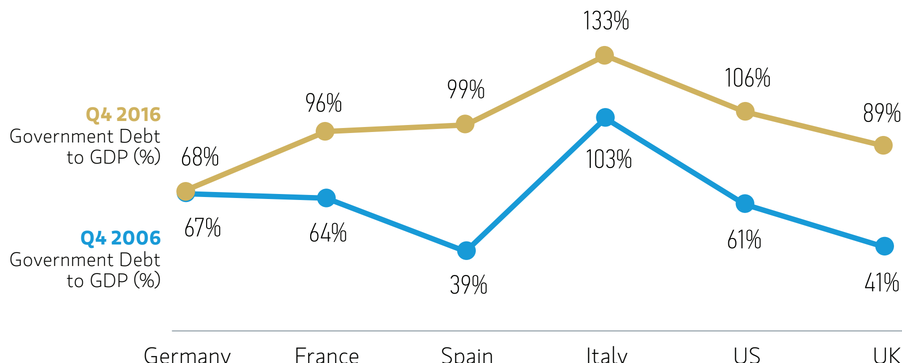
A flood of mortgage-backed securities

Of the $4.4 trillion assets on the Fed's balance sheet, $1.8 trillion were in mortgage-backed securities as of the end of September, accounting for more than a third of total MBS outstanding in the market.[2] The Fed plans to reduce its MBS balance to roughly one trillion dollars by the end of 2021.

Tapering plans call for rolling back around $4 billion of MBS inventory each month for the remainder of this year – not enough to affect MBS trading. In 2018, however, the Fed plans to reduce MBS inventory by approximately $160 billion, which is quite substantial given that net issuance for 2016 came in at $229 billion and is on pace for about $300 billion this year. This means investors will need to absorb about $400 billion in mortgages in 2018. The excess supply will be significant enough to complicate mortgage issuance for agencies and potentially cause a widening of yield spreads in the mortgage market (*Display 4*).

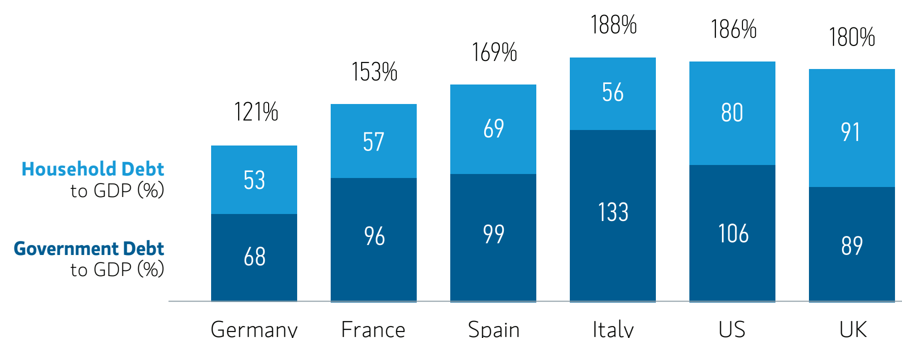
DISPLAY 3

Government debt remains high . . .



Source: Bloomberg as of 16 September 2017.

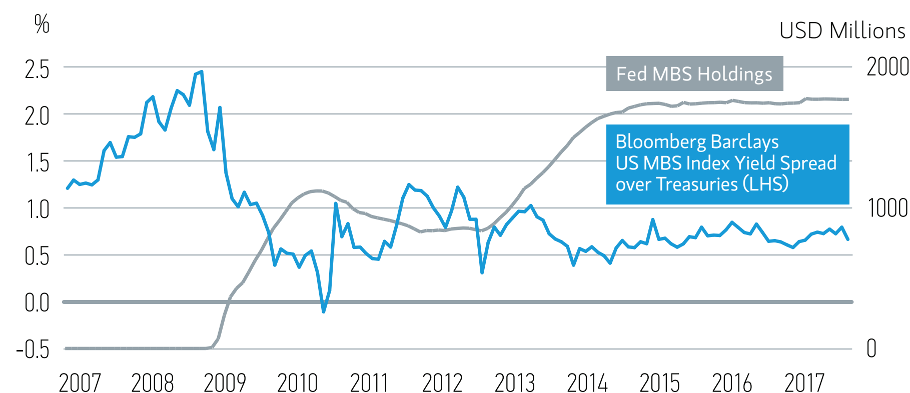
. . . and household debt adds to the burden



Source: Bloomberg for Government Debt to GDP, International Monetary Fund (IMF) for Household Debt to GDP. Data as of end of 2016.

DISPLAY 4

Mortgage spreads could widen when Fed unloads MBS



The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results. See disclosure section for index definitions.** Source: Bloomberg, the Fed, as of 30 September 2017.

[2] Board of Governors of the Federal Reserve System. The Federal Reserve's Balance Sheet. Table 1. Factors Affecting Reserve Balances. https://www.federalreserve.gov/monetarypolicy/bst_fedsbalancesheet.htm Accessed 19 October 2017.

Political storms: Expect the unexpected

There are also potential storms with both political and economic dimensions. President Trump's recent comments about cancelling Puerto Rico's debt dealt a blow to the municipal bond market, serving as an example of how his unexpected and extreme positions can whipsaw financial markets.

The appointment of the new Fed chair is around the corner, too. If that person ends up being significantly more hawkish than Yellen—someone like John Taylor, for example—it could lead to policy changes that would have to be priced into market expectations and this could potentially result in an increase in market volatility.

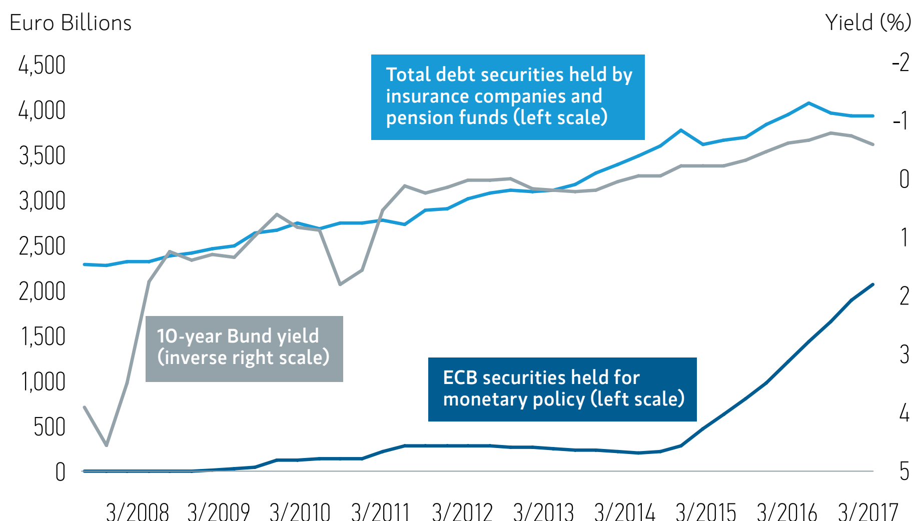
Europe: Decentralising forces

There are political storms brewing in Europe, too. With Catalonia comprising 20% of the Spanish economy, their separatist vote caused a spike not only in Spanish bond yields, but also those of Portugal and Italy, relative to German bunds. Along with the economic contagion into peripheral countries, there seems to be a degree of political contagion as well. Two northern regions in Italy, Lombardy which includes Milan and Veneto, where Venice is located, held nonbinding referendums in October, during which, more than 90% voted in favour of greater autonomy. Meanwhile, Poland, Hungary and even the Czech Republic are becoming increasingly resistant to the European project.

These decentralising forces could be destabilising for both equities and fixed income, leading to greater volatility despite the positive economic perspective on the region. In Poland, for example, the ruling right-wing PiS party is noticeably anti-German, and has even raised the issue of reparations from World War II. Businesses are just shrugging it off, given how closely Poland is linked economically to Germany, but we have seen other instances in which the popular will is not supportive of the country's economic interests.

DISPLAY 5

Pensions & insurance firms own vast amount of debt securities



Source: ECB Statistical Data Warehouse, data as of 30 June 2017. http://sdw.ecb.europa.eu/

European pension funds and insurance: Duration mismatches

As yields have fallen, eurozone pension funds and insurance firms have increased their holdings of debt to nearly four trillion euro,[3] driven by their need to match the present values of their assets and liabilities. Their holdings currently dwarf those of the European Central Bank (ECB) securities held for monetary policy (*Display 5*).

As yields have fallen—to even negative levels in some instances—the present value of future liabilities has increased, forcing pension schemes to invest more into a falling market simply to close the duration gap between assets and liabilities. This dynamic helps explain how longer-term negative yields can persist.

The fall in yields has been exaggerated by convexity effects. Because most of these bonds have longer maturities— historically, more than 95% have maturities greater than two years[4]—the convexity of pension and insurance liabilities is higher than that of their assets. As rates declined, the duration of their liabilities extended more rapidly than their assets, accentuating a duration mismatch and forcing them to buy even more into a falling rate environment.

To some extent, insurers and pension funds are currently under-hedging their duration risks so that when rates start to move up they can seek to hedge at a more profitable level. Nonetheless, rising rates will likely cause the duration of liabilities to fall more rapidly than that of assets. The mismatch is likely to trigger selling of debt securities and magnify the upward pressure on rates.

Germany: Alt-right headaches

In Germany, the growth of the far-right party, Alternative for Germany, is another potentially destabilising political risk. As

[3] Of a total debt level for Europe of nine trillion euros.

[4] Source: ECB's statistical data warehouse.

[5] Once a tropical cyclone reaches maximum sustained winds of 74 miles/119 kilometers per hour or higher, it is classified as a hurricane, typhoon or cyclone depending upon where the storm originates. Source: National Ocean Service – National Oceanic and Atmospheric Administration U.S. Department of Commerce. https://oceanservice.noaa.gov/facts/cyclone.html

the third-largest party in the Bundestag, they would become the official opposition if Merkel cannot form a government with the smaller parties and were forced into another grand coalition with the Social Democrats. This would give them a strong voice in Parliament and potentially create uncertainty about the direction of German policy.

Japan: Finding a path to normalisation

Whilst the Japanese snap election in October strengthened Japanese Prime Minister Shinzo Abe's position, behind the scenes there continues to be discussions on how to wind down the massive economic stimulus over time.

China: Inflation as Achilles' heel

The potential hurricane for China, or rather typhoon, since it would come from the Pacific,[5] is the massive buildup in government debt. This has not been a problem yet because the government has so much control over the economy. If interest rates start rising globally, though, it will be hard for Chinese rates to remain insulated.

The Chinese government keeps the economy growing by printing money, which works well in a low-inflation environment. In a high-inflation environment, however, it could become counterproductive and exacerbate inflation woes. Although this risk is distant, worldwide economic normalisation could lead to inflation in China. This is the Achilles' heel of the Chinese growth model.

Passing storms and rainbows

Although several storms are brewing, some will dissipate or resolve themselves. One or more of them could, however, materialise and cause significant market disruptions. Whilst forecasting the probability of landfall is an inexact science, investors need to have a plan for taking shelter.

At this juncture, we consider it wise to selectively reduce risk. Rather than arbitrarily raising cash, we seek to determine which areas of the market are most vulnerable and position our portfolios in a way that will help minimise the potential for damage. One obvious approach to mitigate the fallout from a sharp and unexpected rise in interest rates is to reduce duration. The goal would be to reinvest and potentially profit from the rebound when the rainbow appears—an outcome we view as extremely likely, given the strength of the underlying economy.

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