Monthly Newsletter

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INSIDE THIS ISSUE

1. Summer Lulls
2. Credit Selection is the Key for Outperformance in the Second Half

Summer Lulls

We wrote about the trade, tariffs, tech & the Thucydides Trap over the past several months so we will not beat on that drum this time. Markets have been optimistic and tolerant with bad global data and with Jay Powell stressing "uncertainties" and "risk" multiple times during his latest testimony, the market is starting to ask for more despite cementing a 25 bps cut. With that said, the bear in my head is constantly whispering…

- Though price can continue to go up, an 11% earnings growth estimate for the S&P 500 *(2020e)* is not a low bar to beat.

- Central banks have pretty much let all the doves out and the "insurance cut" by the Fed, reminiscent of 1995 and 1998, is now in play. If, like in '95 and '98, economic data does improve then great. However, the worry is if cracks in the economy continue to erode and crumble.

- Global economic data continues to point to fatigue in growth and the slew of companies announcing layoffs is not helping sentiment. The bull argument is that US consumer confidence hasn't been as strong since 2000 and the unemployment rate is at its lowest since the 70s. It is worth noting that both of these date points have proven to be "good" contrarian indicators in the past.

These are just a few things to keep in the back of your mind. We understand that "balanced" funds or portfolios will most likely need to rebalance in their 50/50 or 60/40 strategy, given the rally in bonds this year driving global bond yields to new record lows (note: YTD there has been inflows of US$230bn into bonds and US$154bn out of equities).

In the short term, markets are moving into a less liquid period with PMs and traders away on summer vacation. With the Fed vs US-China relations tug of war continuing to dictate the price of risk assets, it may get a little hairy if the US and Iran tensions escalate (interesting to note that summer is the season more prone to war). With the possibility of the latter escalating coupled with the US believing China is still importing oil from Iran, more sanctions could be slapped on, making it more difficult for trade talks to continue. This could force a more aggressive rate cut regime from the Fed.

PIER8 started June with circa 25% exposure to Thailand, Japan and emerging markets. As the market started turning around after G20, momentum took over and risk was built up into Hong Kong/China space. We ended the month up 2.26% with risk primarily in with about 40% of risk in Asian equities. It was a month of relief rally after a corrective and very disruptive May (especially the last week). While there were good vibes from the G20 on the Sino-US front, there is still a lot of scepticism over the potential outcome. US and Europe are running on their respective central banks' dovishness which sent their equities into an overbought status according to our model. We will remain side-lined in these markets until the signals improve. Emerging markets on the other hand are faced with:

1. the surface of export curb from Japan to Korea, pushing earnings expectation even lower for Korea
2. the spill over from Baoshang for China credit concerns
3. the decline in PMI around the world

The dovish backdrop should lift EM despite the overhang of Sino-US tension while the Japan-Korea uncertainty seems to be baked into the discounted price action in the Asian equity markets. Current positioning of the QM (systematic) book is a reduced long in Asian markets like Taiwan, Korea, Japan and China whilst avoiding the "overbought" US/EU equities. We continue to be defensive in sectors such as healthcare, consumer staples and uber luxury.

Credit Selection is the Key for Outperformance in the Second Half

RACS is positioned for a rate cut at the end of July. There are various justifications, but the three most compelling are: 1) inflations expectations - as indicated by the University of Michigan, 5yr-10yr inflation expectations fell to historical lows in June to 2.2%, 2) the ECB has indicated further easing due to persistent growth concerns, and 3) the federal funds to the 30yr treasury briefly inverted in June. The inversion of the 30-year and federal funds rate has happened only six times since 1980. And five of those times it took place just before a significant pullback in stocks: the double-dip recessions of 1980-1982, the savings and loan crisis of the late 1980s, the Asian debt crisis of 1997, the bursting of the tech bubble in 2000 and the Great Recession of 2008 (source: Bloomberg, CNN).

If you have been long Asia high yield credit this year, your returns should be close to 10% year-to-date. The question is, how do investors position for the second half of the year…lock in profits, or stay invested? This question is even more pressing for equity investors, year-to-date the S&P and Hang Seng are up approximately +20%. The markets have climbed a wall of worry with the strong US labor economy bolstered by dovish remarks by central bankers. Investors whom have hedged their equity portfolios with fixed income have gained extra performance from the declines in treasury yields.

This balanced portfolio approach will continue to work in the second half, but individual stock or bond selection will become important and the differentiating factor for performance. The market has already priced in two rate cuts for 2019 and potentially two more cuts in 2020, but with trade tensions disrupting global supply chains and deterioration in business and consumer confidence, the cuts will not be as impactful. The Fed is pushing on a string – monetary easing can only boost confidence to a certain degree but cannot help improve profit margins for companies nor directly increase aggregate demand.

The impact for investors is that the stocks of companies with lower leverage tend to perform better in declining interest rate environments versus peers with higher leverage. The rationale being lower leverage companies tend to have higher margins and have more maneuverability during times of business disruption (please contact us for a more detailed report on this topic). On the fixed income side, the backdrop remains benign. Draghi set the tone in the middle of June by suggesting another round of QE is in order. In June, negative yielding debt hit a record of USD12.5 trillion. The German 10yr hit its lowest yield, -0.40%. The spread between the German bund and US treasury stands at nearly 200bps. From this perspective USD denominated debt still looks attractive.

Asia credit markets have done well in the first half. Over 50% of the market consists of China related credits and starting in May, many LGFV credits have come to the market. Investor appetite has kept up, but we are now at a point where new issues are no longer performing. The secondary trading for new issues is flat or slightly below reoffer for many issuers. Pricing has become expensive. For example, Greenland HK priced at 9.875% in December 2018 for 1.5-year maturity which is now trading at 5.5% for the remaining 1year. In early July, the same entity priced a 2-year new issue at 6% which is trading at 5.6% in the secondary market. Given the current valuations, expect returns for the 2nd half be mainly driven by coupons.

The Rockpool Alpha Credit Strategy is taking a barbell approach of short-dated high yield bonds and longer-dated investment grade bonds. The benefit of this approach is a reduced mark-to-market, steady cash flows, and a potential boost if interest rates trend lower. Additionally, the extra yield potential will come from private credit opportunities that are not available to the broader market. These investments have yields above +10% for reasonably high-quality security collateral.

RACS portfolio achieved 0.93% since inception in May.

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