Camdor GLOBAL ADVISORS
FINDING LASTING SOLUTIONS IN AN UNCERTAIN WORLD

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Macro Matters: An Introduction

The UK's recent decision to leave the European Union came as a shock to many, and has created confusion and uncertainty whilst also reaffirming lower rates for longer. The impact on pensions funds and insurance companies has been brutal with the shift downwards in the yield curve impacting funding positions across the UK by £80bn, according to some estimates. This has been accompanied by the perfect storm of credit spread widening and volatility in equities. More worryingly, the gilt curve is negative in real terms across the whole curve, adding further pressure to the already frantic search for yield and returns.

But Brexit is also just a moment in time. Going forward, there are many moving parts in the macro picture, all of which impact both asset allocation and prudent risk management. The path of the UK economy over the next two years is uncertain and the signage of most predictions of GDP will be informed more by political leanings than hard analysis. The prospect of pain in Europe is very real, given the increasing populism and underlying debt strains across the continent. China continues to slow down and contributes over eight times more to the global economy than the UK. Most importantly, the fragility in the global system has been highlighted and the risk of contagion across multiple asset classes is real, should sentiment shift.

But for every risk, there is also a dislocation that represents opportunity for those willing to look past the noise and analyse these dynamics. The best returns over time accrue to patient capital that takes its time to study the world holistically and understand the broader dynamics playing out. It can then avoid or mitigate those risks that are unrewarded; accept those that are rewarded and assess how best to play them; and establish timeframes, targets and tolerances to optimise the risk-return trade-off as a whole.

In short, macro matters more than ever. The need to take a step back and distil the bigger picture is critical. At Camdor Global Advisors, careful analysis of opportunities and mitigation of risks is fundamental to our thinking. To that point, we wish to share with you a fuller version of a short note that we wrote for IPE magazine in May 2016, summarising the macro risks we perceived at the time for our clients' portfolios.

Macro Matters: An Introduction cont.

Brexit was highlighted, but we focused on what we see as a far greater threat - the implications for European cohesion and a scenario we termed EUxit, that is now playing out across Europe today. But as noted above, Brexit is not the only risk brewing in this ever complicated world. In the attached note, we also include brief analyses of the drivers for other key macro risks that we monitor and track over time.

We hope you find it a useful input into your investment and risk process, and please don't hesitate to contact us if you have any questions or wish to discuss further.

Bob Swarup

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Key Macro Risks

This quarterly column assesses four key buckets of macro risks relevant for pension funds and insurance companies at a high level; and with a view to their evolution over the next 12 months. We also delve into more detail on particular dynamics that bear further thought. These often cross multiple buckets reflecting the interconnectedness of our world today. Importantly, this is not an isolated point in time exercise but rather a regular updating to aid assessment and inform action.

Key Risk 01

Geopolitical & Socio-political

Impact = Medium to high

Political risks are elevating, as economic nationalism rises and international coordination falters. Brexit looms large, with only a few weeks to go now till polls open, and within Europe, clear tensions are emerging between Germany and the ECB. In the US, Trump's victory in the Republican primaries emphasises the shift towards isolationism and labour protectionism, a nuance also appearing now in Hilary Clinton's statements. Tensions over China's push to own the South China Sea are set to escalate as the Permanent Court of Arbitration in The Hague is set to rule on the first of several disputed island territories, in this case between China and the Phillippines.

Key Risk 02

Financial Markets

Impact = Medium to low

Markets have stabilised in recent weeks, as central bankers (including the US) reiterate dovishness and amplify the monetary methadone. But beneath the surface, fragility is increasing. The yield curve is firmly in the lower for longer camp, exacerbating liabilities and ALM mismatches and continuing to fuel the crush for yield amongst investors that has typified the last half decade. Assets are buoyed technically once more, but we expect bouts of volatility as markets periodically question the efficacy and power of policymakers. Emerging markets continue to be driven by two things alone: a) how will China resolve its souring debt pile, and a) will their currencies fall further against the US dollar?

Key Risk 03

Economic

Impact = Medium to high

Developed economies are generally long in the tooth now when it comes to the business cycle and the next recession. It is no longer a question of if, but rather when and how best to manage the economy through it. Will we see the further proliferation of negative rates?

In the US, earnings may have beaten expectations but productivity is falling – for the fourth time in the last six quarters. Meanwhile, wages are rising and will continue to do, once minimum wage hikes are taking into account. That is negative for corporate margins, profits and ultimately share prices. Alongside, the rush of private capital into the debt markets has boomed and there is a huge overhang of dry powder looking for debt homes. Leverage continues to increase and we expect covenants to weaken further.

Key Risk 04

Other

Impact = Medium to high

The rise of the robots is also leading to the rise of economic patriotism and labour protectionism. The minimum wage hikes and their repackaging as living wages are one example. The obsession with migrants is another. There is a growing clash between technology and toil, which threatens to derail potential future drivers of growth at the expense of social stability today. We note the march of the unicorns may also find missteps as investors question the multiples.

The word 'climate refugee' is also about to enter the popular lexicon. The US recently welcomed its first climate refugees, the Biloxi-Chitimacha-Choctaw tribe, as their island home was reclaimed by coastal erosion. This will be a growing theme, not just for societies (e.g. the fractious battle over water rights in many countries) but also for investors. For example, 46% of the assets of the 17 largest REITs lie in areas prone to flooding and cyclones.

Brexit or EUxit?

11/05/2016

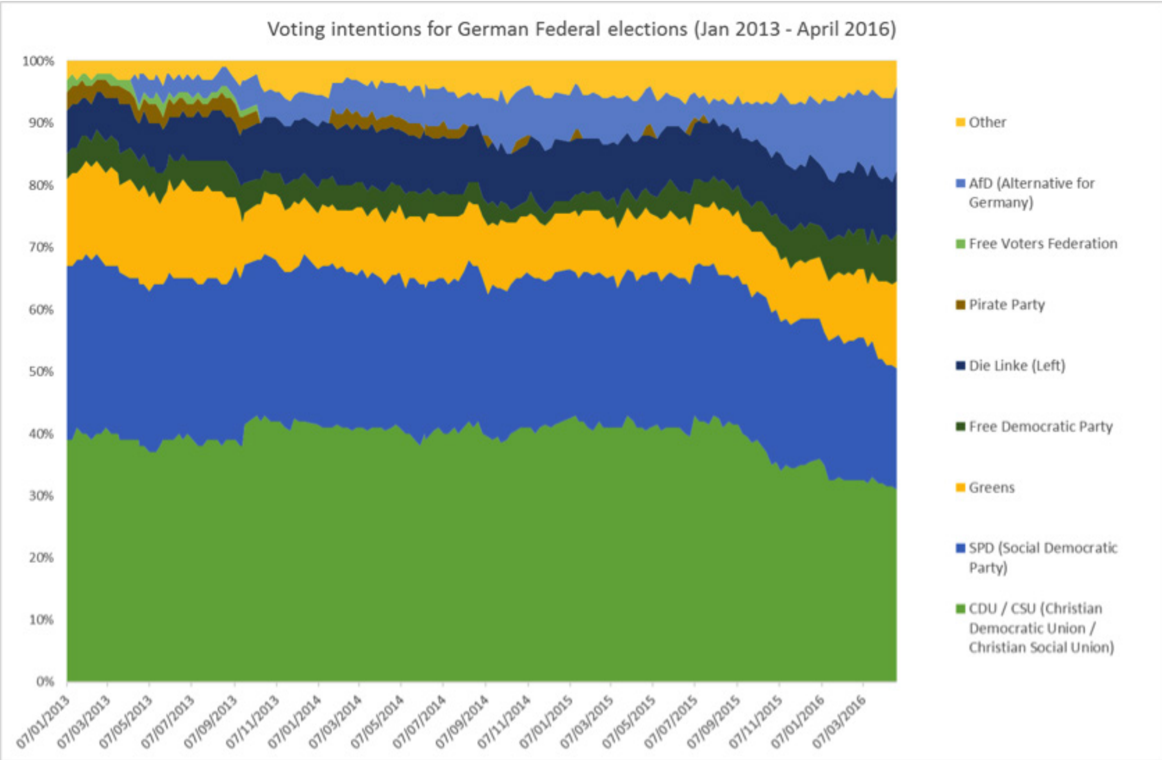
It would be hard to not talk about Brexit and its implications, given its dominance of discussion these days. Much of the recent debate and analysis has focused on Britain's ability to negotiate free trade agreements and the impact of different scenarios on GDP. The immediate aftermath is simple: the currency weakens, investment stalls as the fallout is assessed and households save more amidst uncertainty. But past that, all analysis is speculative. In the event of Brexit, the final impact on GDP and its signage will be determined largely by the charm and skill of the team put together to negotiate future trade agreements.

What is hardly discussed is the impact of Brexit not on Britain but on the European Union (EU). This is the real elephant in the room and where real risks to the global economy lie. The furore over Grexit demonstrated the turmoil that the potential exit of a (tiny) member state could have on the far larger EU.

The exit of the UK in this context is a far more damaging hit. The UK is both the second largest economy (17.6% of the EU) and net contributor (£8.5bn in 2015) after Germany. Europe can ill afford such an exit, as its economy remains fragile in the face of a persistent deflationary environment and an uneven halting recovery. Beneath the surface, the complex web of debt that haunted Europe remains alive and well, despite bank deleveraging.

Brexit weakens the sovereign guarantee and credit backing for many European nations, opening the door to another raid by bond vigilantes. Further, it leaves Germany isolated as the sole country capable of bailing out others if needed. That is a tough ask, given recent worries about fiscal prudence and the growing tensions between Germany and the ECB.

In this volatile mix, Brexit may leave Germany feeling even more isolated. Germany is now beginning to question the European project – a national bout of soul searching exemplified by the rise of AfD (Alternative for Germany), a far right populist party that is Eurosceptic and anti-immigration. Since launching in 2013, its popularity has grown rapidly. Today, it holds seats in eight state parliaments and has about 12-14% of the vote.



Voting intentions for German federal elections (Source: YouGov Germany, Camdor Global).

The tail risk here is that a Brexit only accelerates either a German exit as the price demanded for bailouts becomes politically unpalatable or a renewed attempt by Germany to reassert control over the European project. The latter unfortunately would only accelerate anti-European sentiment amongst other nations.

The National Front in France is already campaigning for 'Frexit' and a return to the franc. It won the largest share of the vote in recent regional elections – nearly 28%. Across Europe, eurosceptic parties are on the rise, all supporting a refocus on domestic priorities and a weakening or outright rejection of the European project. Brexit provides them with a template. It forces the EU to put together a process and create tangible terms for exit. It also enhances the bargaining power potential leavers. Once opened, this 'exit' genie may be hard to put back in the lamp.

Much as QE quantitative easing became conventional, EUxit may well become a reasonable policy option for EU leaders as they seek to minimise domestic pain, solidarity be damned.

About Camdor Global Advisors

Camdor Global Advisors is an independent economic and strategy advisor to pension funds and other institutional investors. Our principals have many years of real world, hands-on experience in investment strategy and risk management across multiple asset classes and for multi-billion portfolios.

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About the Principals

Dr Bob Swarup...

...is a respected international expert on financial markets, investment strategy, alternatives, ALM and regulation. He is the founder of Camdor Global, an advisory firm that works with institutions and investors around the world on strategic investment, risk management, ALM and business issues.

Bob was formerly a partner at Pension Corporation, a leading UK-based pension buyout firm, where he oversaw alternative investments, was Chief Risk Officer and ran Thought Leadership. Bob has also served on the Advisory Board of Adveq, a leading Swiss PE firm; the Board of CatCo, a $2bn reinsurance hedge fund that he helped seed in 2011; and on several committees of the ABI.

Bob is a Fellow of the Institute of Economic Affairs; a Senior Visiting Fellow at Cass Business School; and an Associate at Lombard Street Research. He holds a PhD in cosmology from Imperial College London and an MA (Hons) from the University of Cambridge. Bob has written extensively on diverse topics, including putting together ALM for Financial Institutions: Balancing Financial Stability with Strategic Objectives on the challenges for ALM going forward. His latest book is the internationally acclaimed bestseller Money Mania on two millennia of financial crises and the lessons to learn (Bloomsbury, 2014).

Daniel Schrupp...

...is a seasoned investment professional and a former insurance company senior executive. Prior to CG Advisors, Dan was Chief Investment Officer at Lucida plc, a UK insurer focused on the pension buyout and bulk annuities markets. At Lucida, Dan was in charge of investment strategy, portfolio management of internally managed funds and selecting and overseeing third party managers. Dan successfully led Lucida into alternative credit asset classes including leveraged loans, private debt, ABS and infrastructure debt.

Prior to Lucida, Dan was a Senior Portfolio Manager at Aozora Bank where he managed a $4.5 billion portfolio of U.S. and European leveraged loans. Prior to Aozora, Dan spent 13 years as an investment banker focusing on corporate finance at Salomon Brothers Inc., Brown Brothers Harriman & Co., and CIBC World Markets. Dan has a bachelor's degree in economics from Yale University and a Masters of Business Administration from the Tuck School at Dartmouth College.

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