GavekalDragonomics

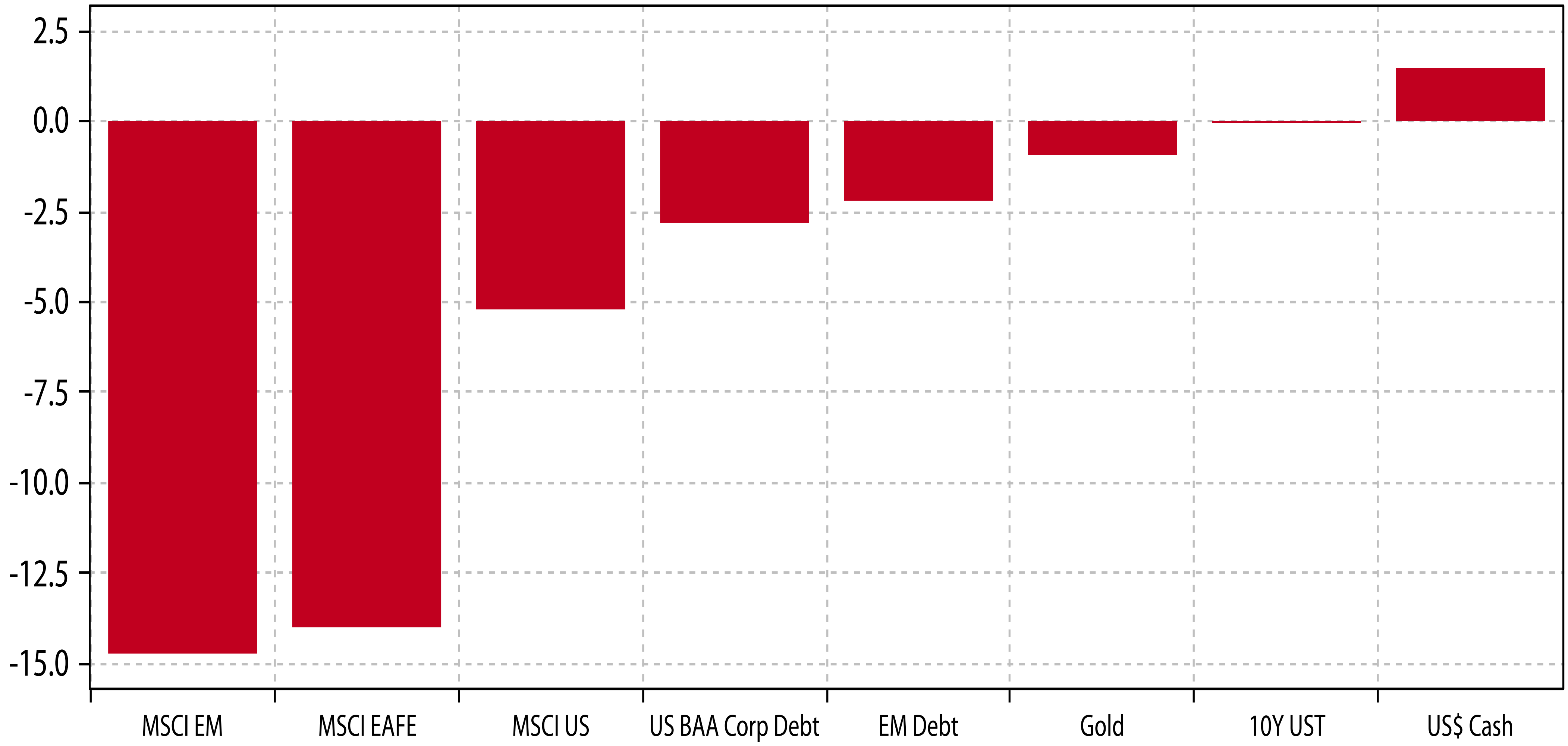
January 2019

Explaining 2018
Confronting 2019

Louis-Vincent Gave

Why was 2018 such an ugly year?

Total Returns of Various Asset Classes in US$ for the 2018 Calendar Year



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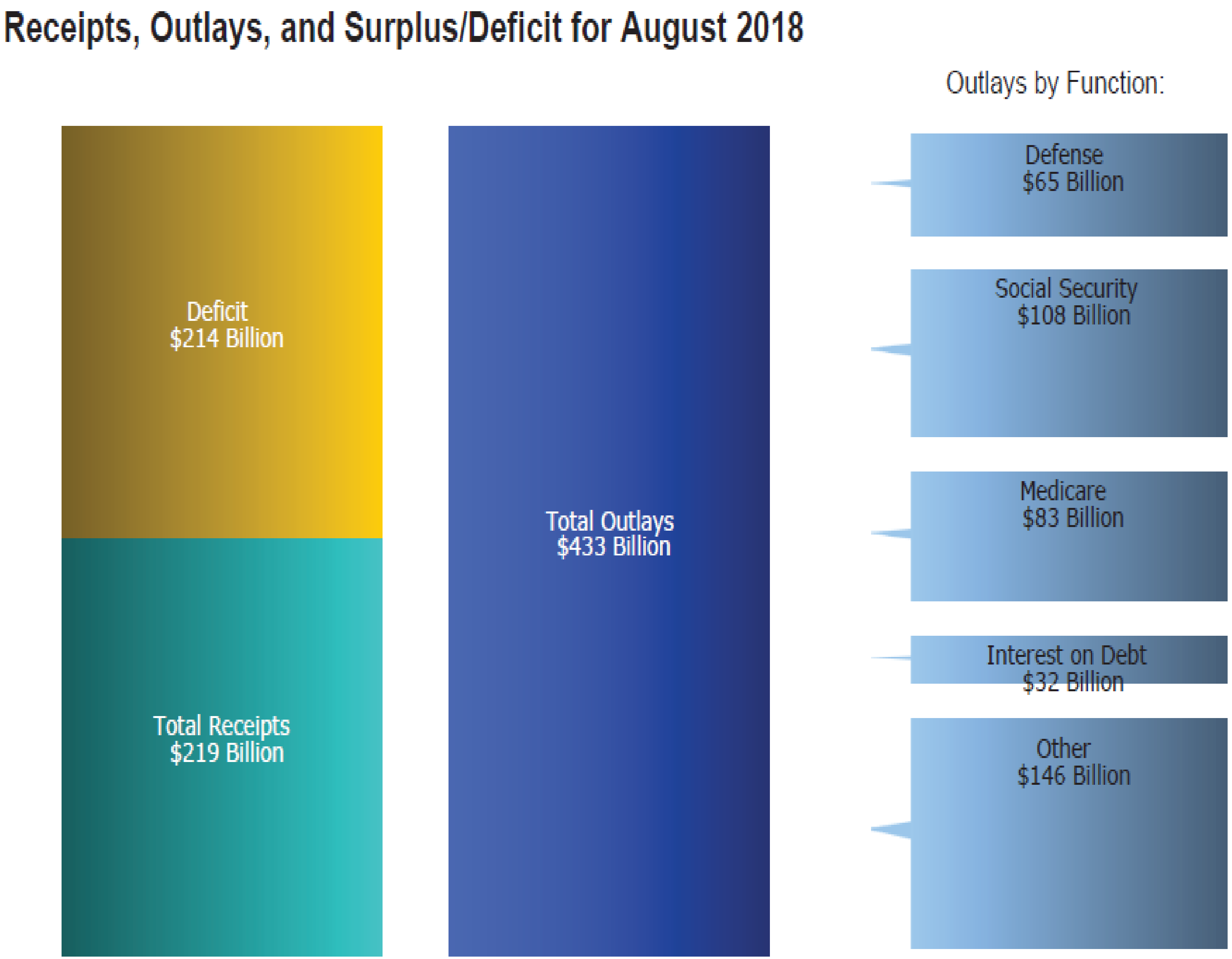
1- The cyclical explanation:

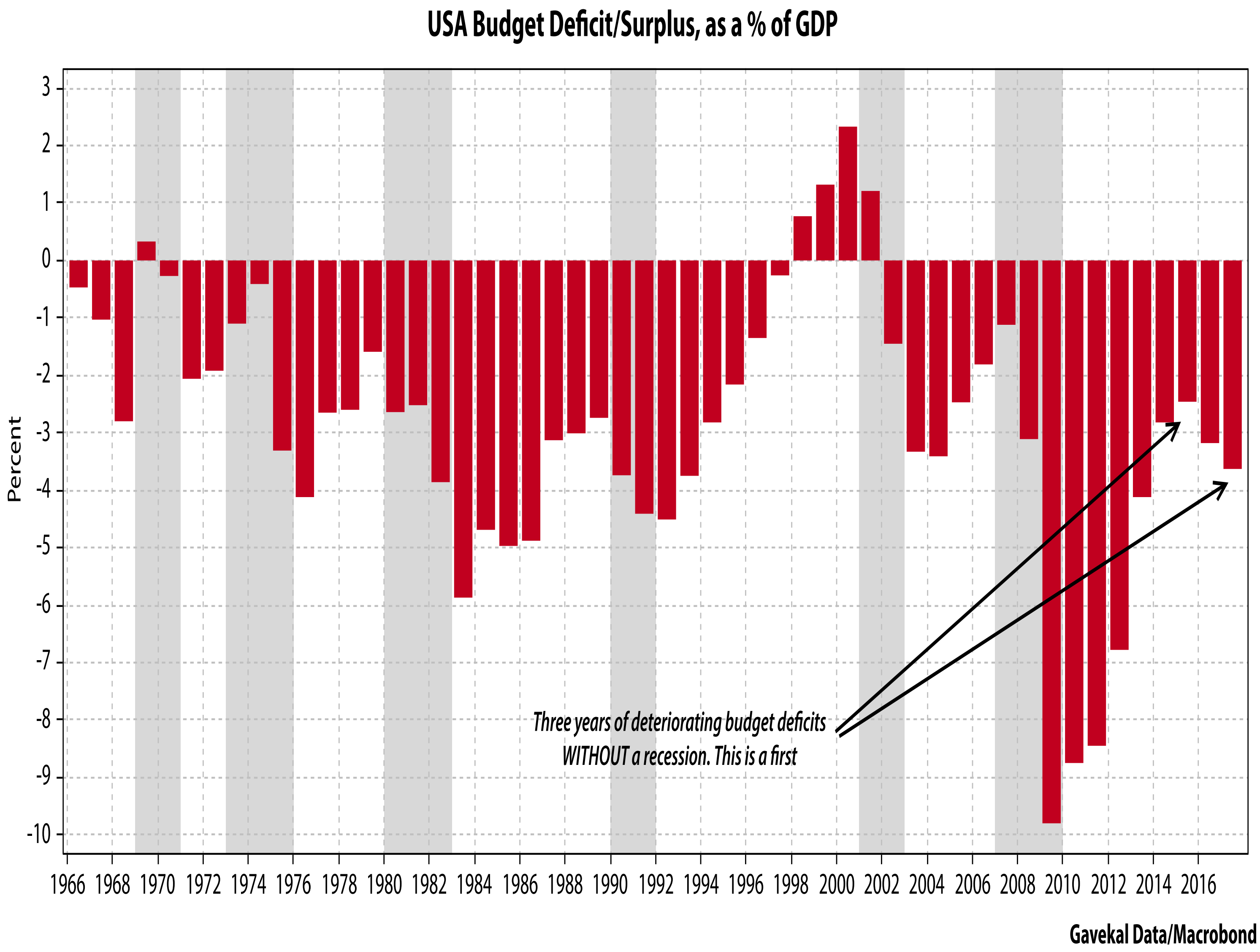
'more fools than money'

Is US government spending now crowding out everything else?



- **In August 2018 for the first time ever, US tax receipts were not enough to pay for social security + medicare + interest on outstanding US debt**.
- Out of outlays of US$433bn, the US government out had to borrow roughly half.
- Is it a coincidence that things started to go haywire on global markets right around that time?

Amazingly, US budget deficits have expanded in spite of solid growth

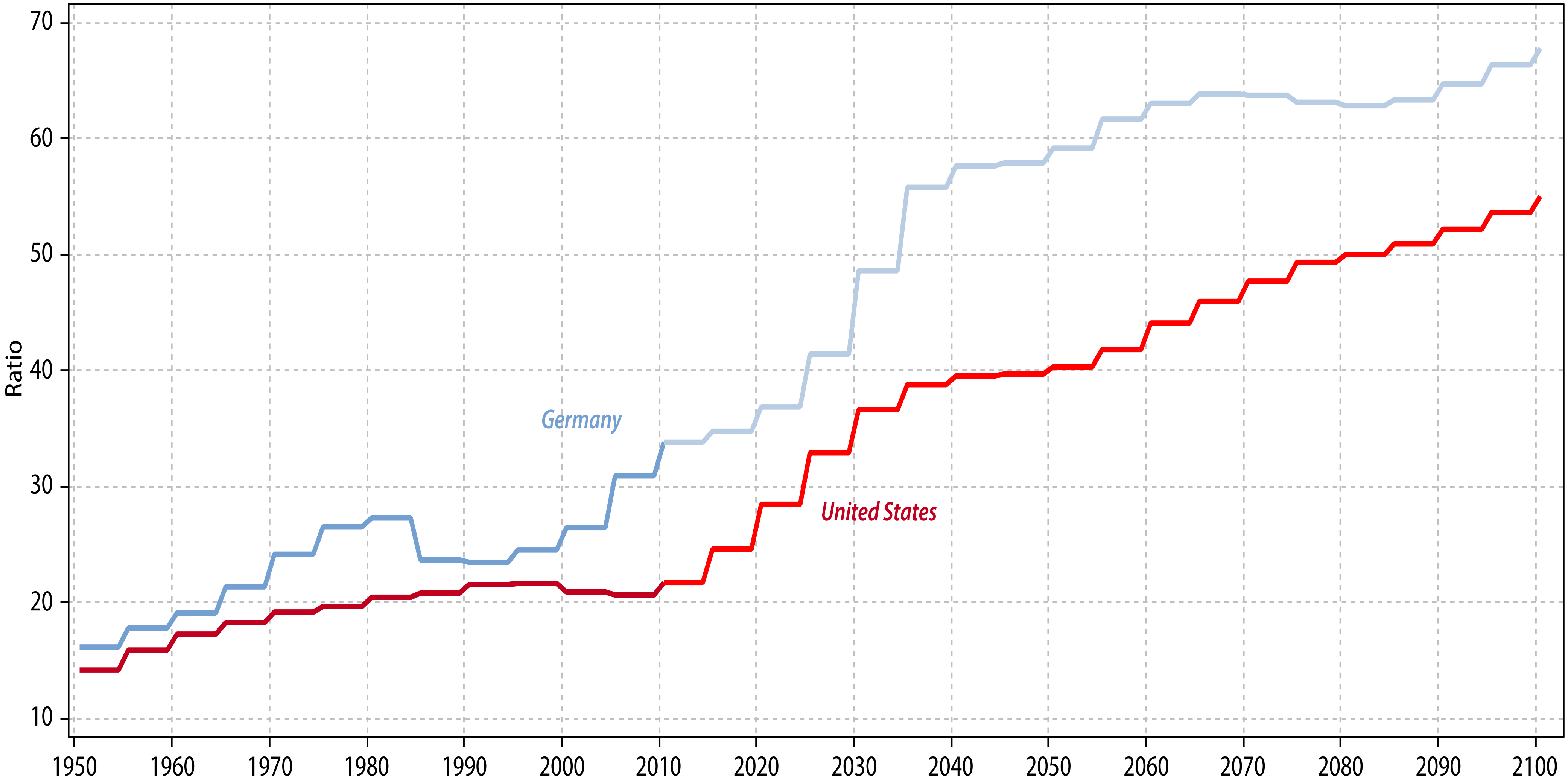


- In spite of record high tax receipts, the US budget deficit has once again expanded in 2017.
- Continuous years of budget deficit expansions have NEVER occurred without a recession. **So this is a new development for the US economy**.
- In essence, this tells us that government spending in the US is now growing much faster than government revenues, **even when the economy beats expectations and asset prices make all time record highs**.
- So what happens next? Will the US government:

  a) ***shrink spending,***
  b) increase tax revenues or
  c) continue to expand deficits?

Deficits are growing because of demographic reasons

Old-Age Dependency Ratio (Ratio of Population Aged 65+ per 100 Population 20-64)



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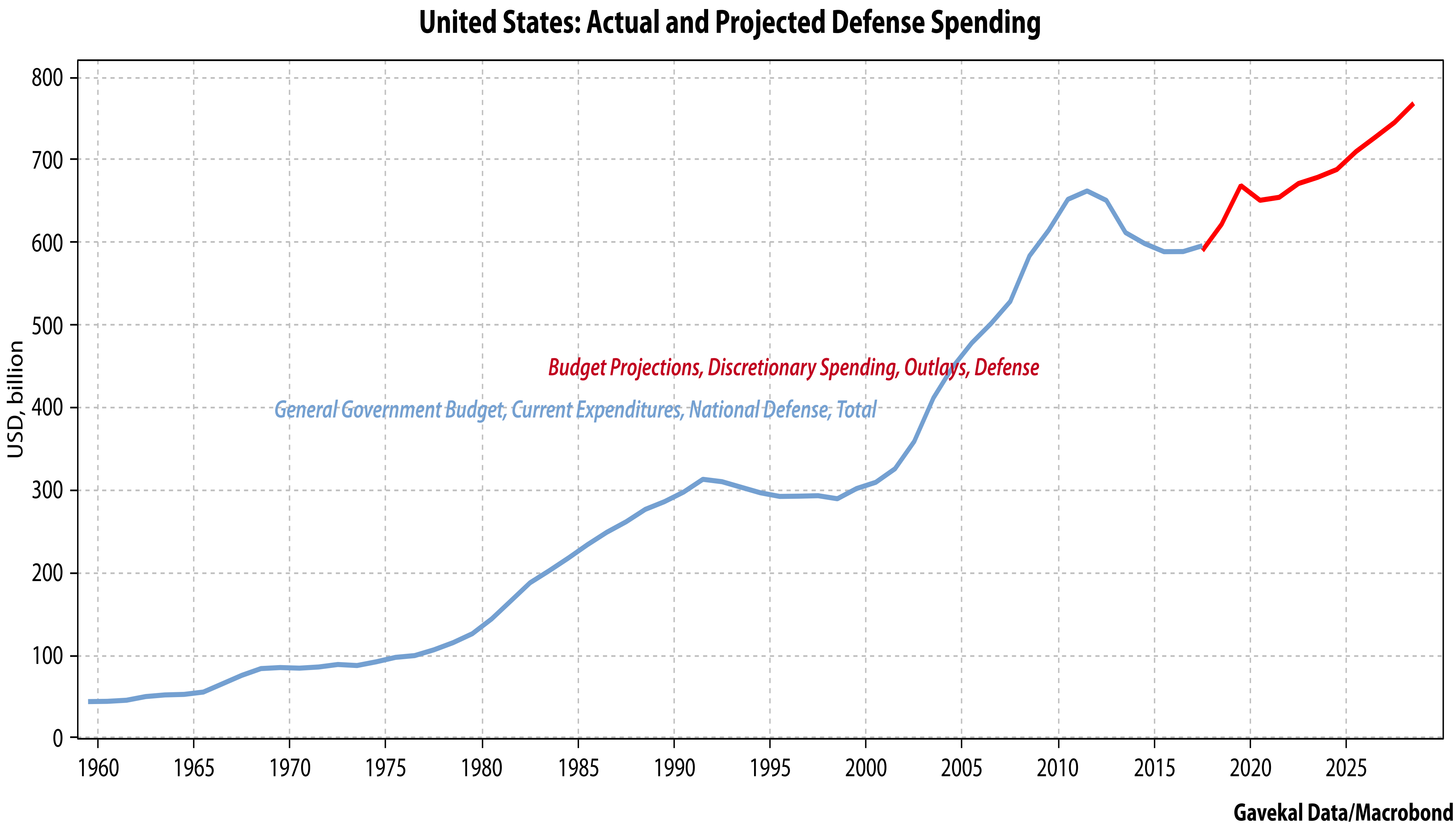
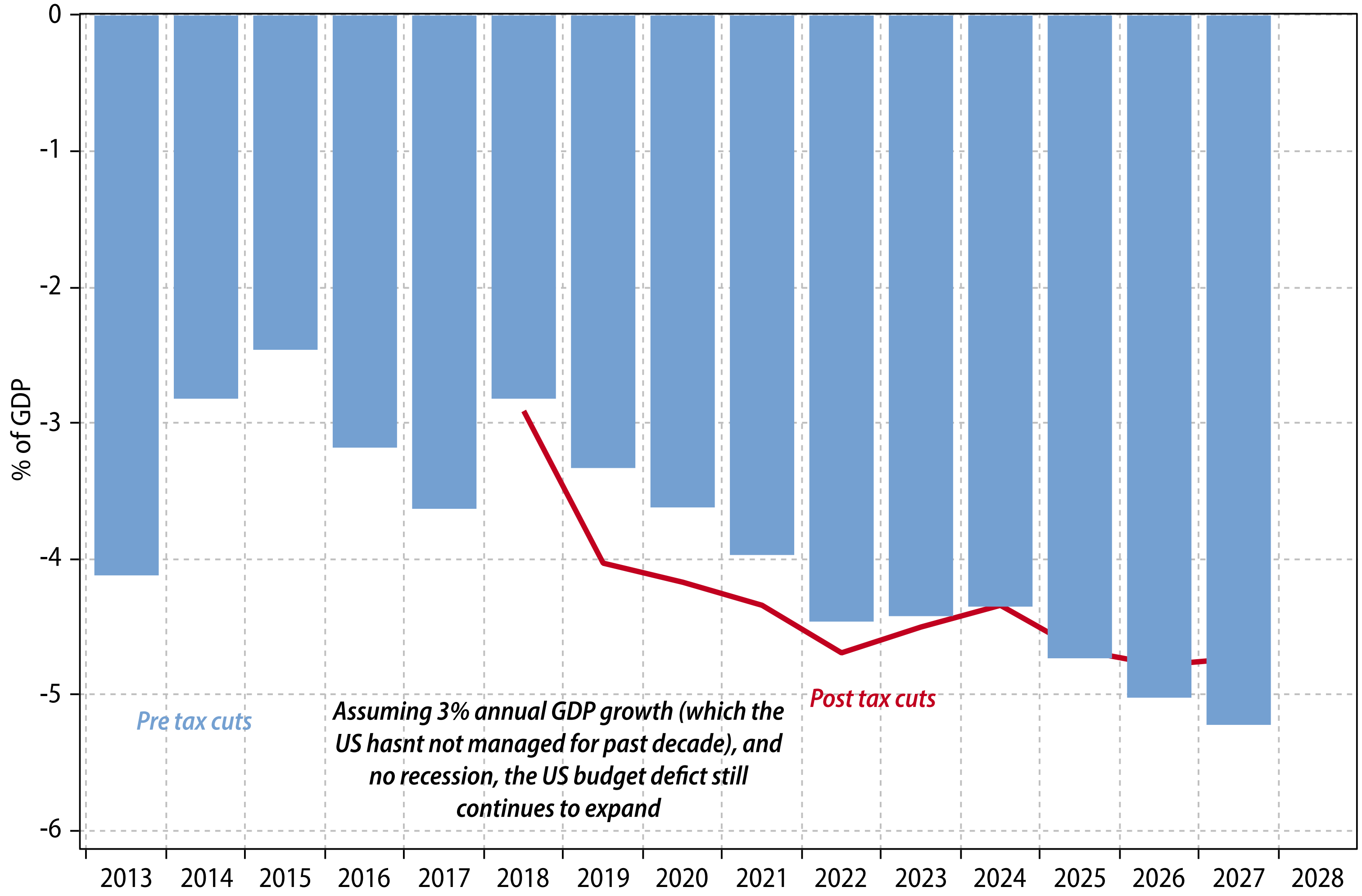
Unlike Europe, US is not sacrificing its Army to keep its welfare state (or will it?)



So who will fund the growing US budget deficits?

The US budget deficit will continue expanding in the coming years

CBO projections, with post-tax estimates based on JCT dynamic scoring



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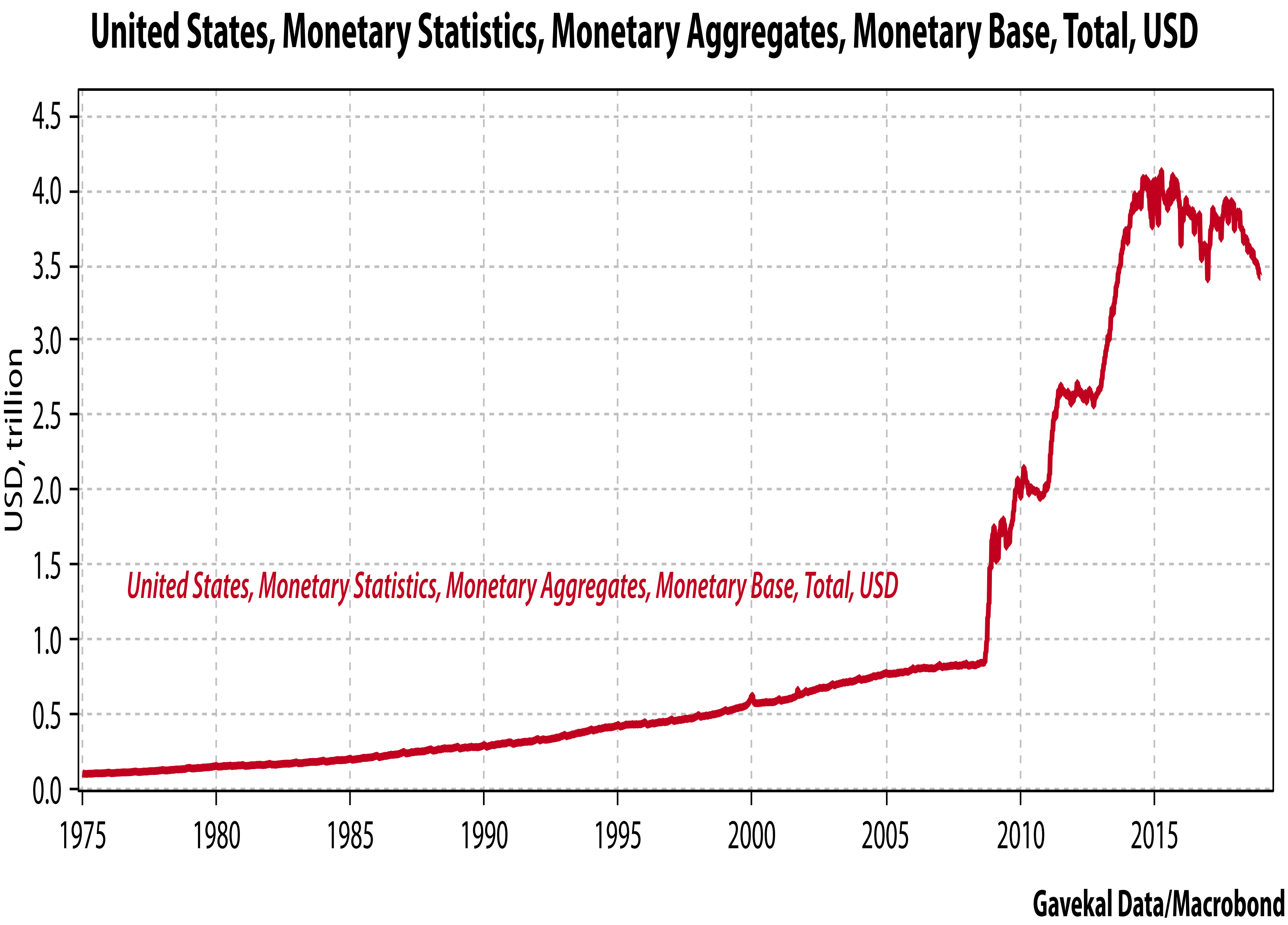
- According to the CBO, on forecasts that do not include a US recession (which would mean that the US would have gone two decades without a recession for the first time), the US budget deficit is scheduled to steadily deteriorate to -5% of GDP.
- Does this mean that the US government will increasingly 'crowd out' private sector investments and suck liquidity out of the system?
- Just this year, the US Treasury will issue US$1.3tr NET worth of US government bonds.

Jay Powell has made it clear that the Fed won't fund US deficits



- More than the continued hikes in interest rates, the reduction in the Fed balance sheets is most likely what is weighing on markets.
- Indeed, on the one had we have a US government that, like a massive Leviathan needs ever more money.
- On the other, a Fed no longer willing to feed to beast.
- Thus, the Leviathan needs to feed itself in the private sector… Which means that money comes out of the 'liquidity reservoirs' such as equity and bond markets…

The fish have emerged, now where is the whale?

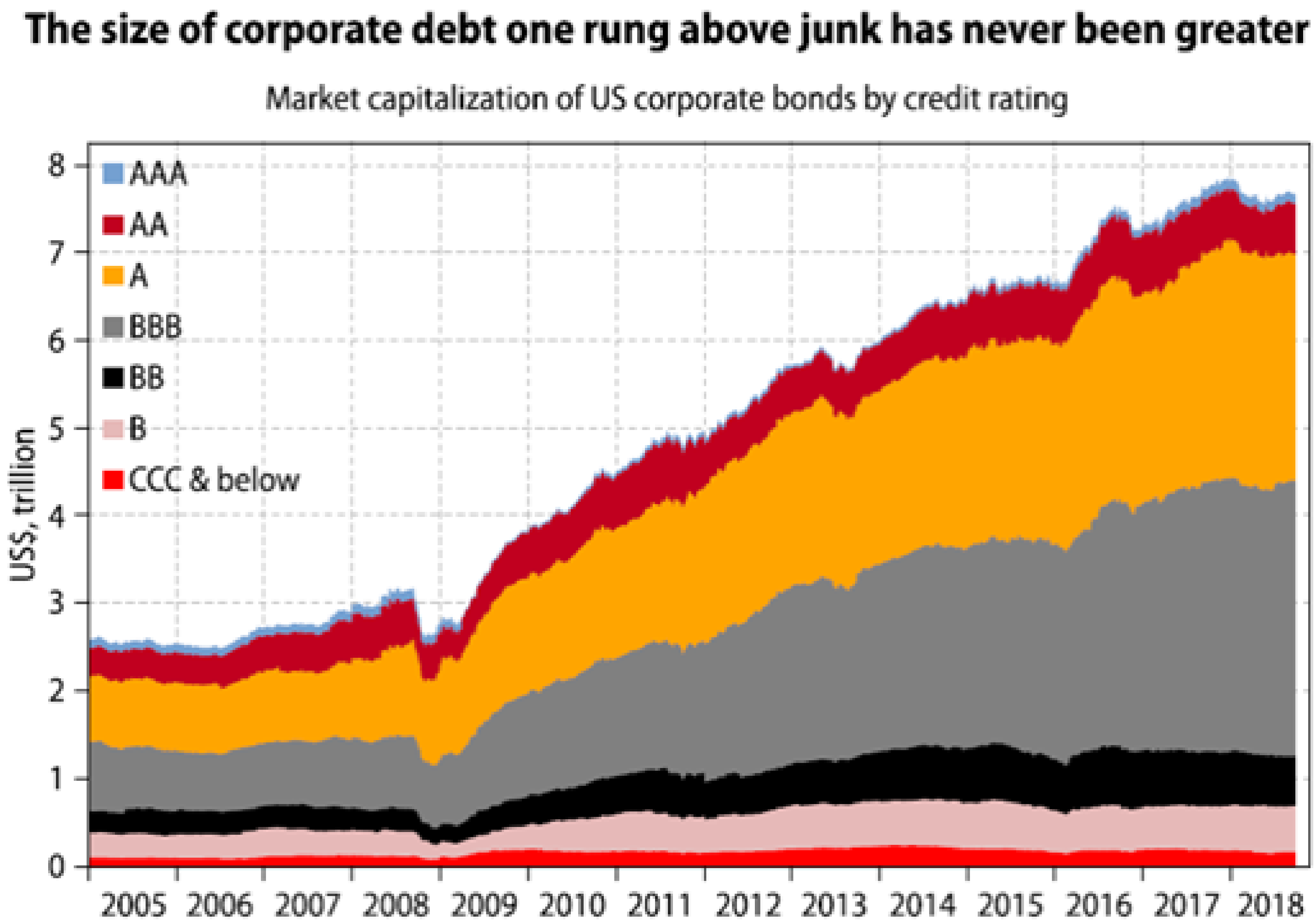
Where will the whale emerge?

A 'whale' involves the death, or near-death, of an entity big enough so as to trigger an important shift in fiscal, monetary or regulatory policies. In the most recent crisis, the biggest whale of all was AIG. It was AIG hitting the wall that triggered the postponement of 'mark to markets'. So if we are in a liquidity squeeze, who will the whale be?

- Ask a Frenchman and the answer is **likely to be Italy…**
- Ask an Italian and the answer is **likely to be Deutsche Bank…**
- Ask a German (or an Alsatian like Charles) and the answer is **likely to be France…**
- Ask a US hedge fund manager and the answer is **likely to be China…**
- Ask me, and I would say the **US Corporate Bond Market**

2- The problem with the US corporate bond market

Global ZIRP has encouraged a surge in US corporate bond issuance

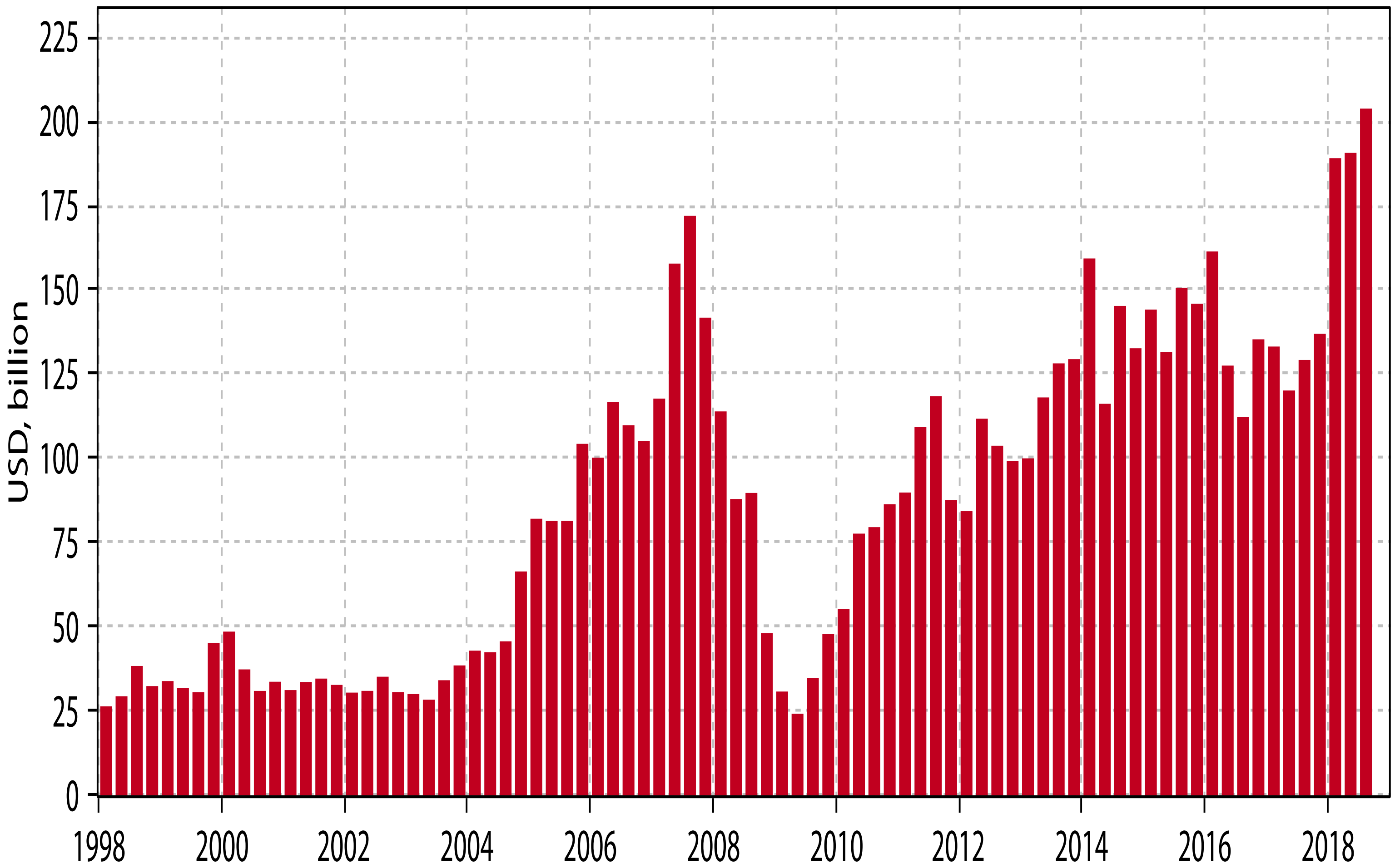


Has the rise in corporate debt funded assets to service the debt?

- US corporate debt relative to GDP is already at levels that are usually only seen in recessions (when debt goes up and GDP goes down).
- So one could argue that it already is "different this time" when it comes to financial engineering?
- It is hard to know how much longer can it last – but one thing is sure, spreads will matter

Or has it funded unprecedented financial engineering?

USA sharebuybacks smashed records in the second quarter



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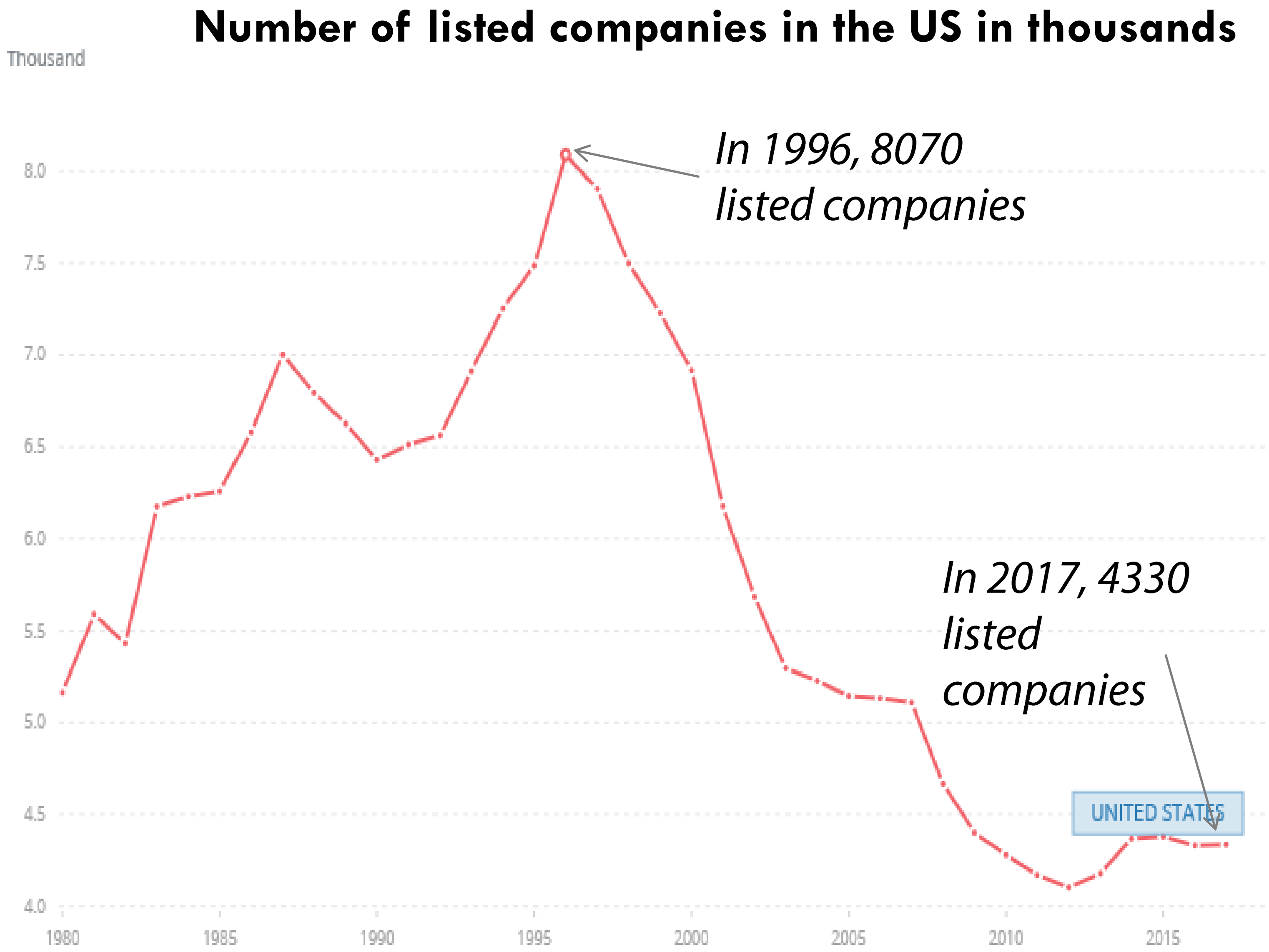
- The last quarter of this year witnessed a record US$200bn in share buybacks for the S&P!
- 2018 has smashed all records for share buybacks: we are on target for US$750bn+ for the year

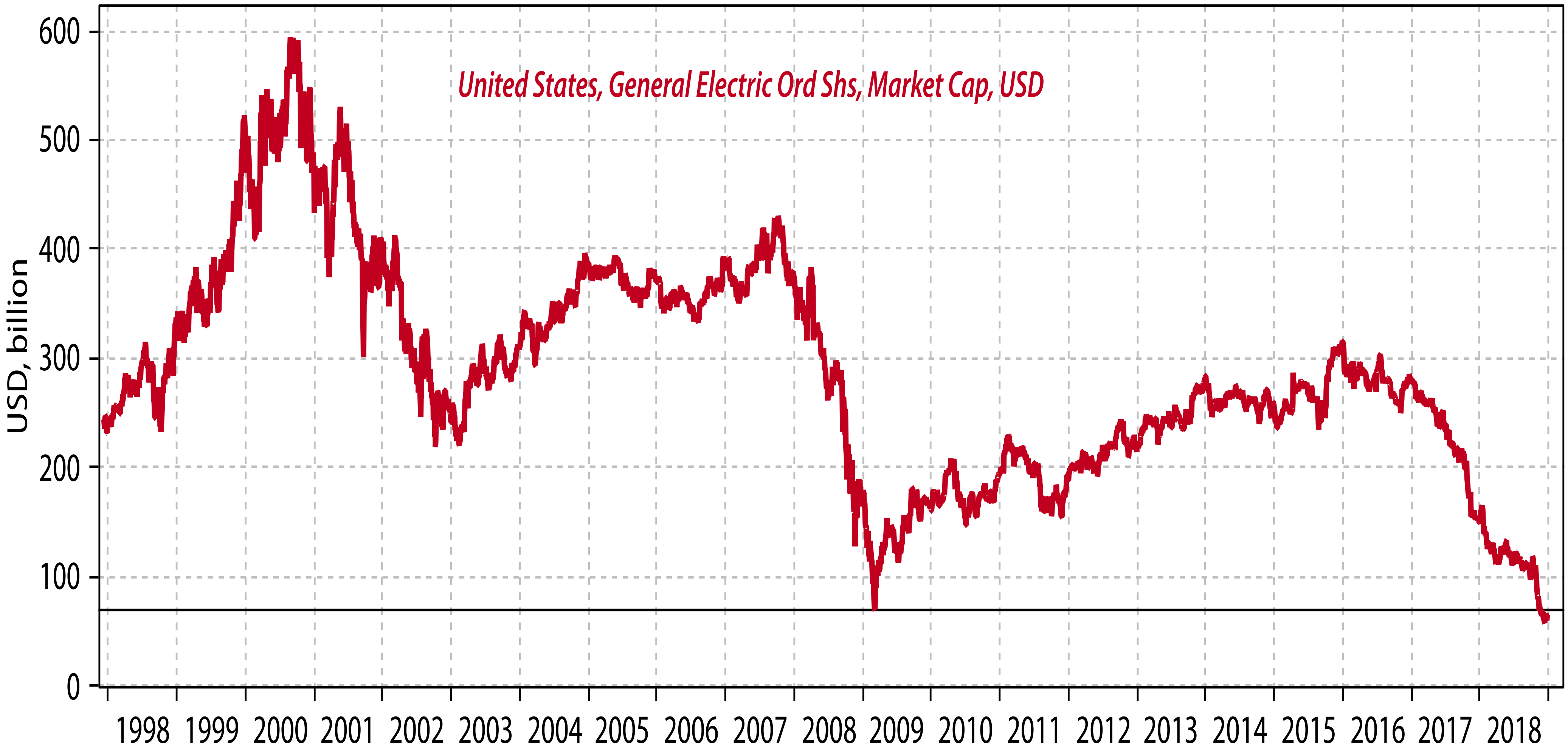
At the current pace, US equities will soon be rarer than Siberian tigers



- US stocks are becoming as rare as Siberian tigers. Pretty soon, we will all be invited to charity galas to save listed equity vehicles…
- Maybe the US outperformance is simply linked to the shrinking pool in which investors can deploy an ever expanding capital base?
- We are ten years in a bull market, and still no massive IPO cycle?

General Electric: winning all the battles and losing the war

Is this the whale?



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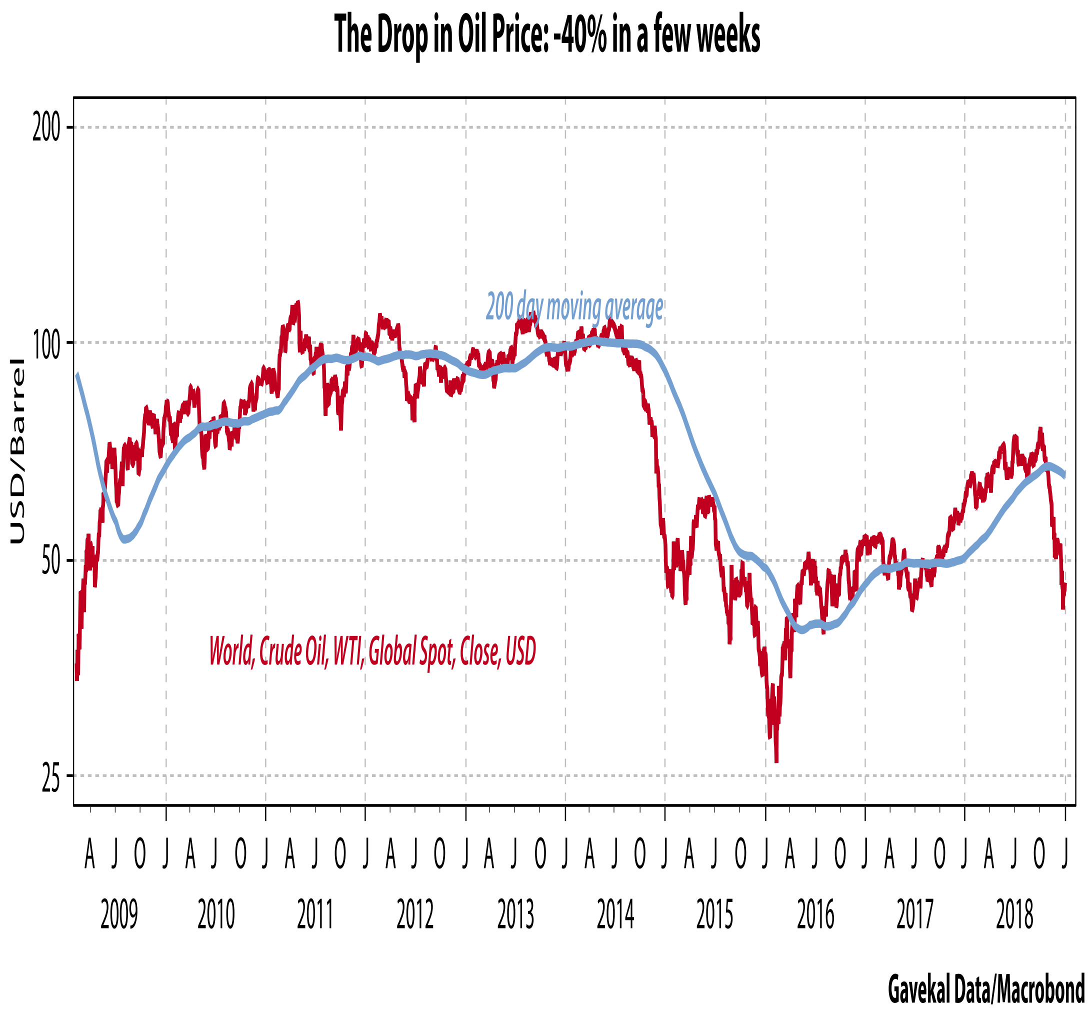
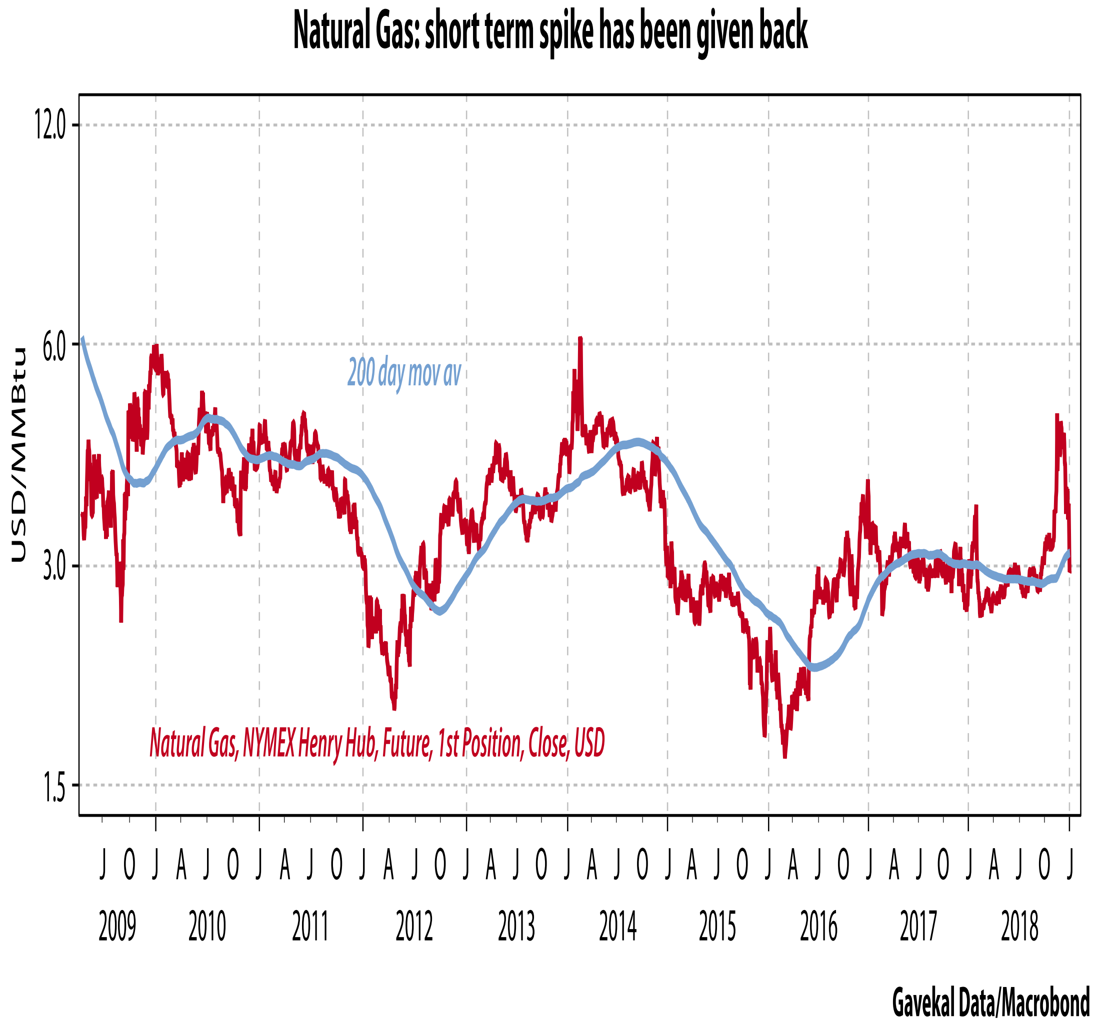
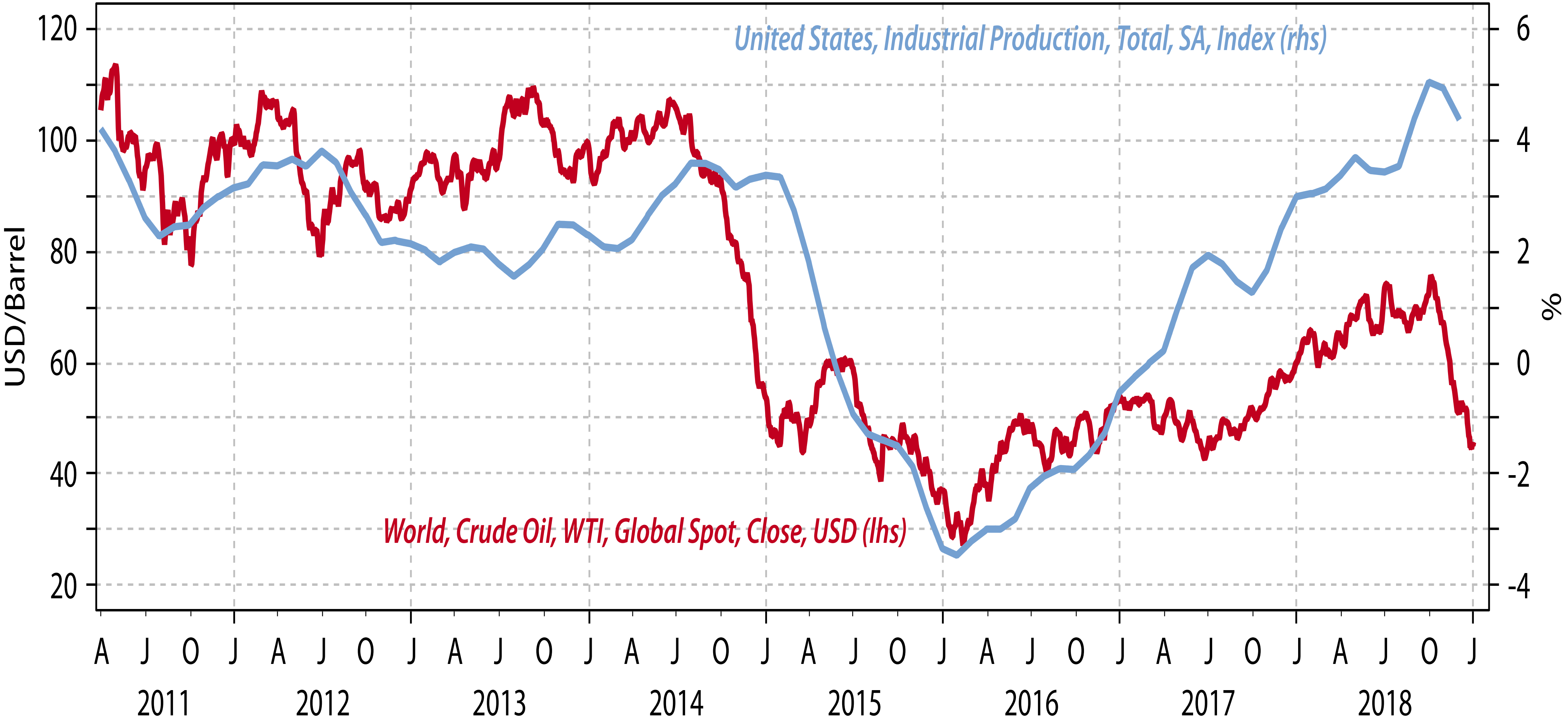
"Too low" an oil price could also be problematic for US





If oil stays weak, what does that mean for US growth?

Can US industrial production stay strong with oil tanking?



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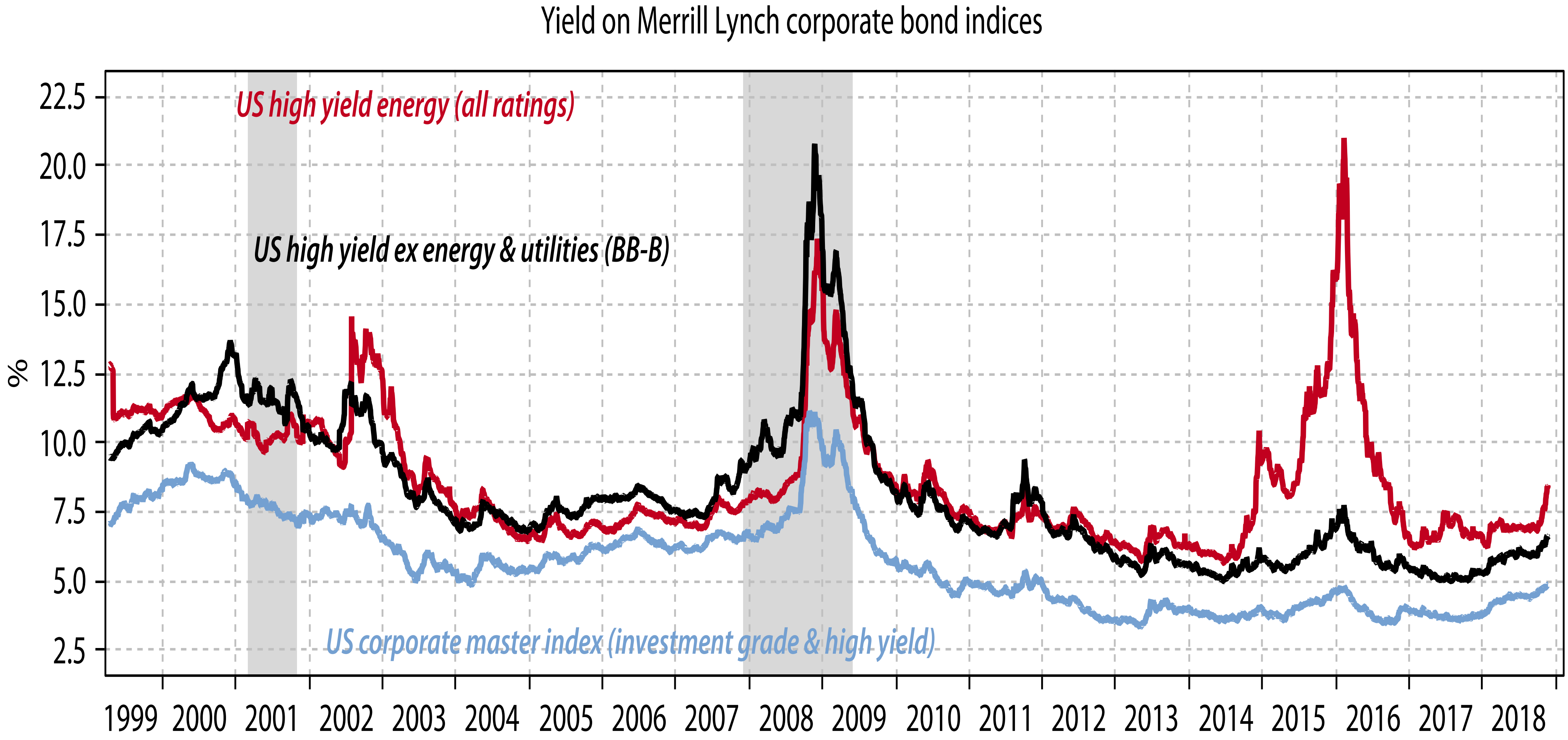
Perhaps more importantly, what would it mean for US spreads?

Corporate yields have risen since the summer, but to different degrees



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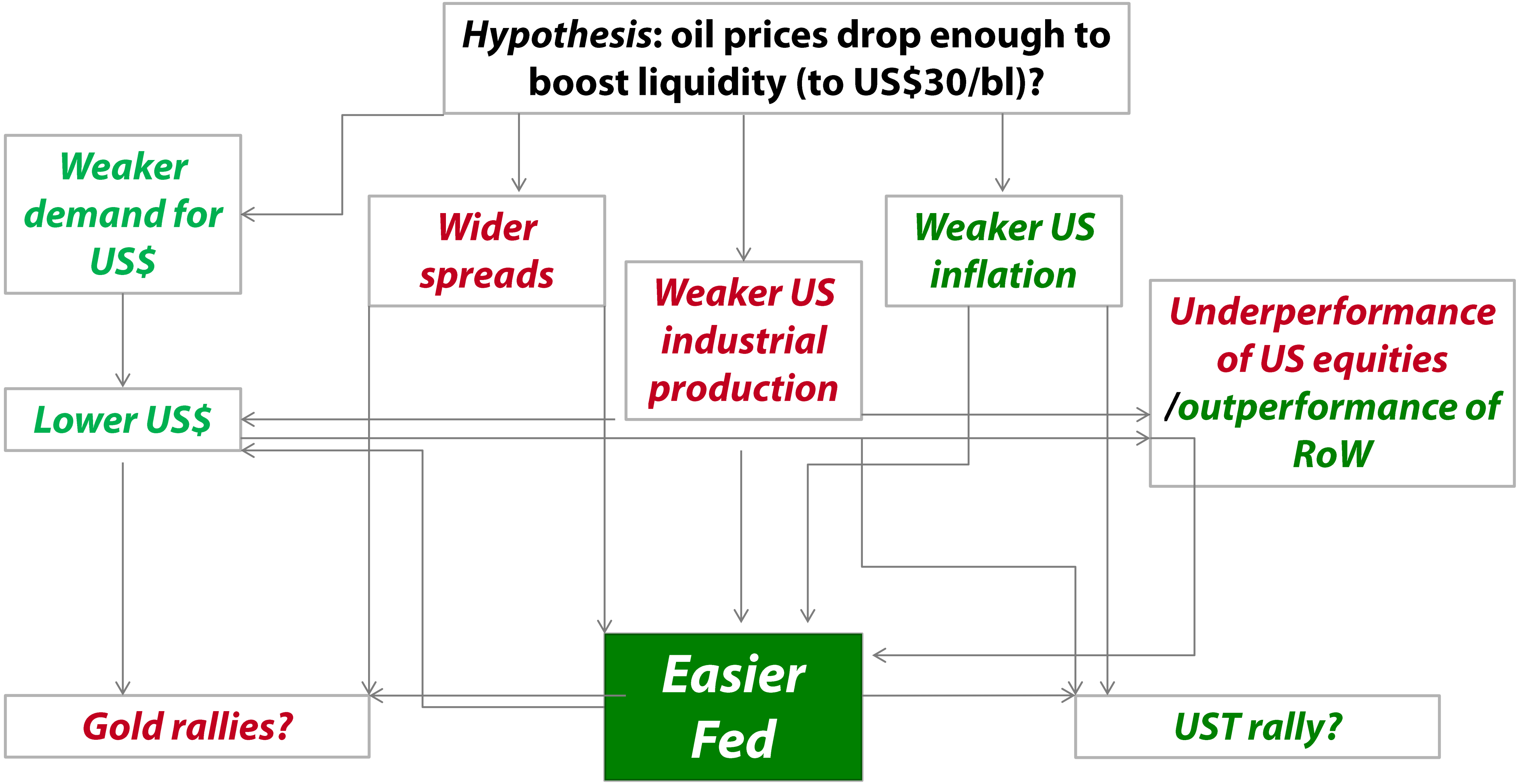
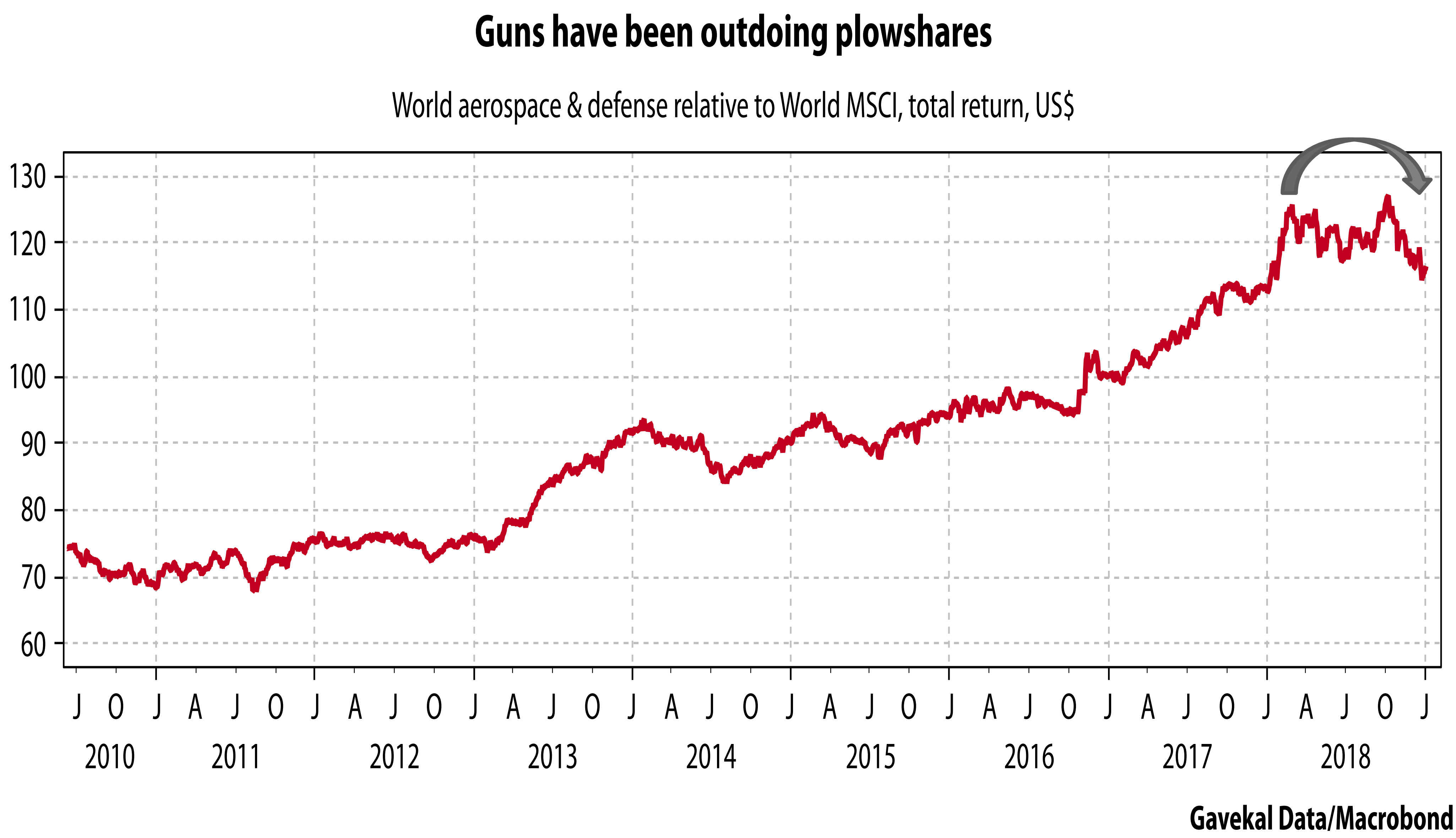
Lower oil = weaker growth = wider spreads = easier Fed = weaker US$?



As oil falls, and as US budget deficits rise, sell US defense stocks



3- Towards an easier Fed?

Let's face it: almost all the news-flow in 2018 was very bullish US$

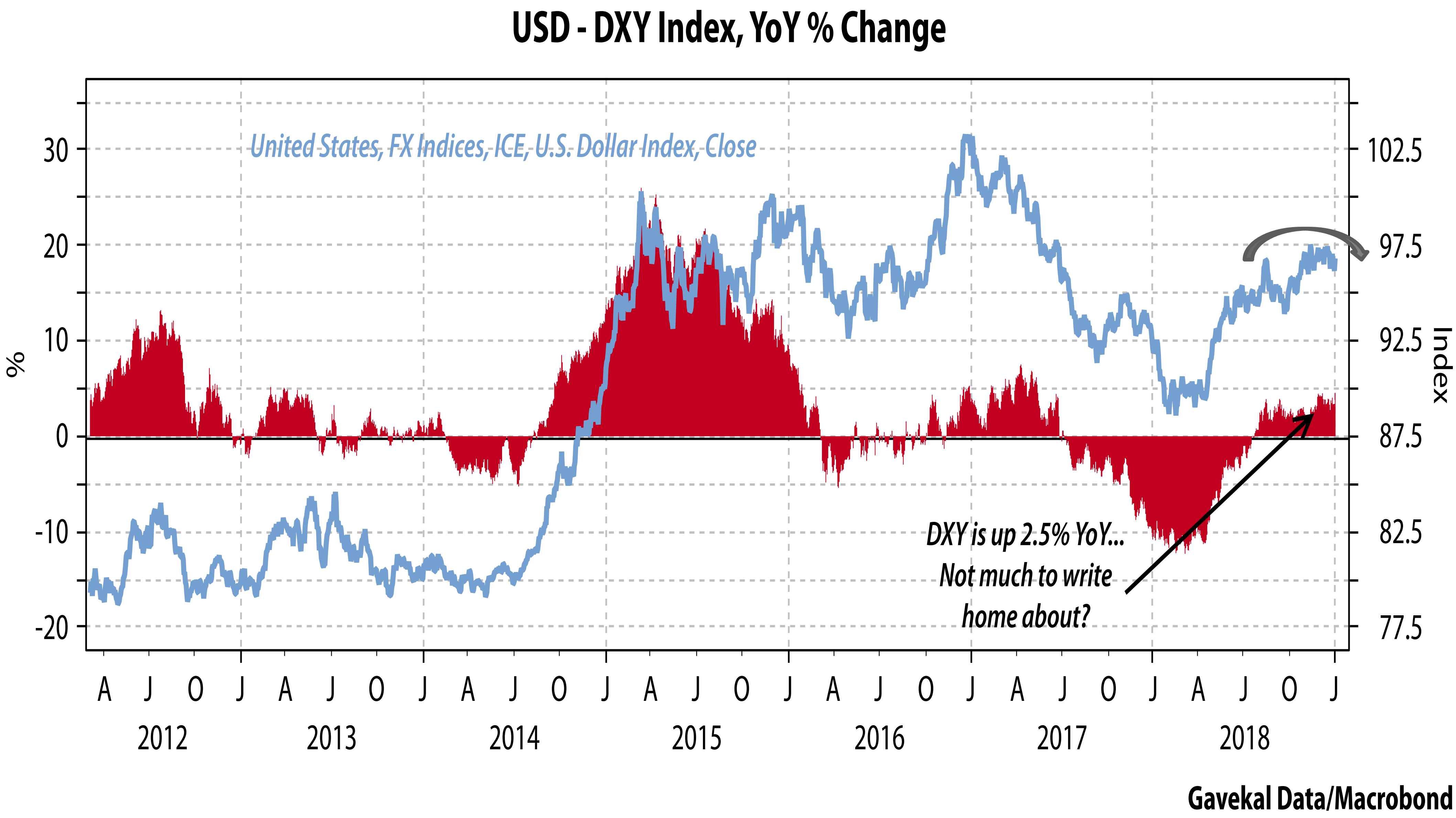
Usually, in a liquidity squeeze, one would expect the US$ to rise. This would be doubly true for the past year given that, in 2018, we witnessed:

- An implosion in emerging markets
- A more hawkish Fed than was originally expected
- A renewed crisis in Italy
- Significant outperformance of the US economy against most other DM & EM
- A higher than expected oil price until the fourth quarter
- Much higher long term interest rates in the US than other DM
- A significant 'risk-off' in global equity markets in the last quarter of the year

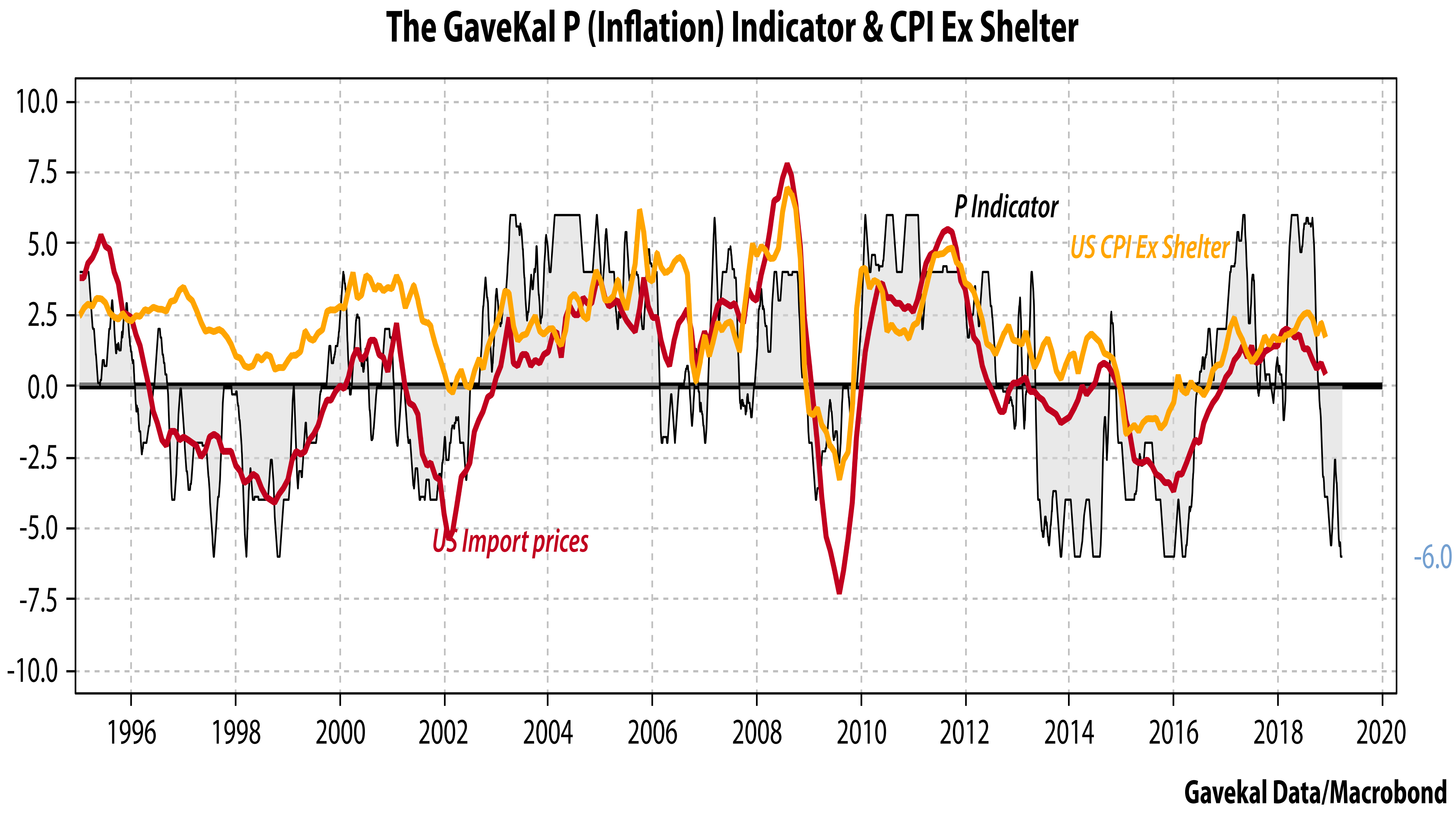
Yet, with all of this, the US$ hasn't rallied very much, if at all.

In other words, **the US$ is increasingly behaving like a stock that "doesn't go up on good news**". Is this because everyone is already very long? Or because the market is starting to anticipate some tougher news ahead for the US? Or something else?...

If we are in a liquidity squeeze, why isn't US$ much much stronger?

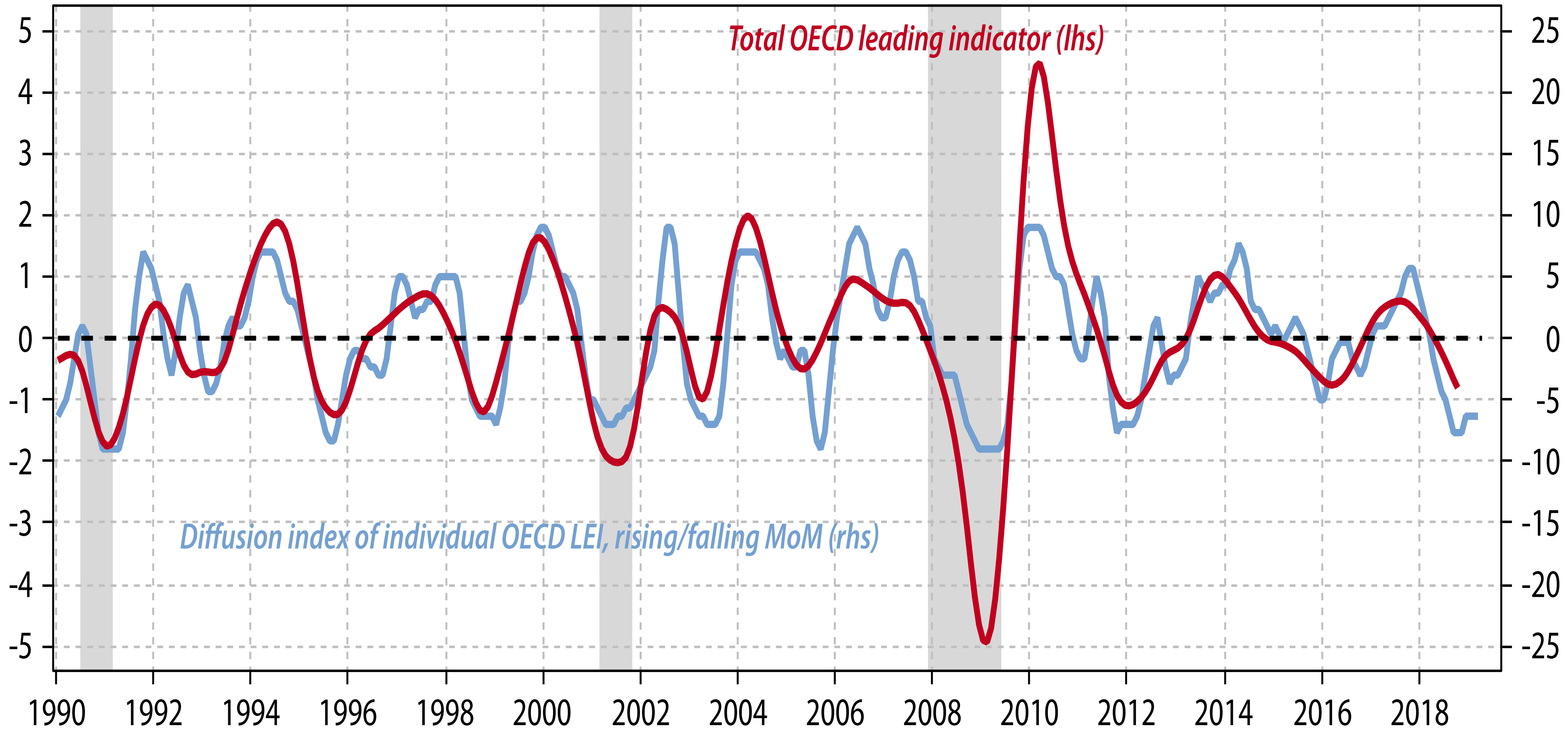


With inflation expectations collapsing, Fed should be easier in 2019



With weaker growth, Fed should be easier in 2019

Leading the OECD Leading Indicators



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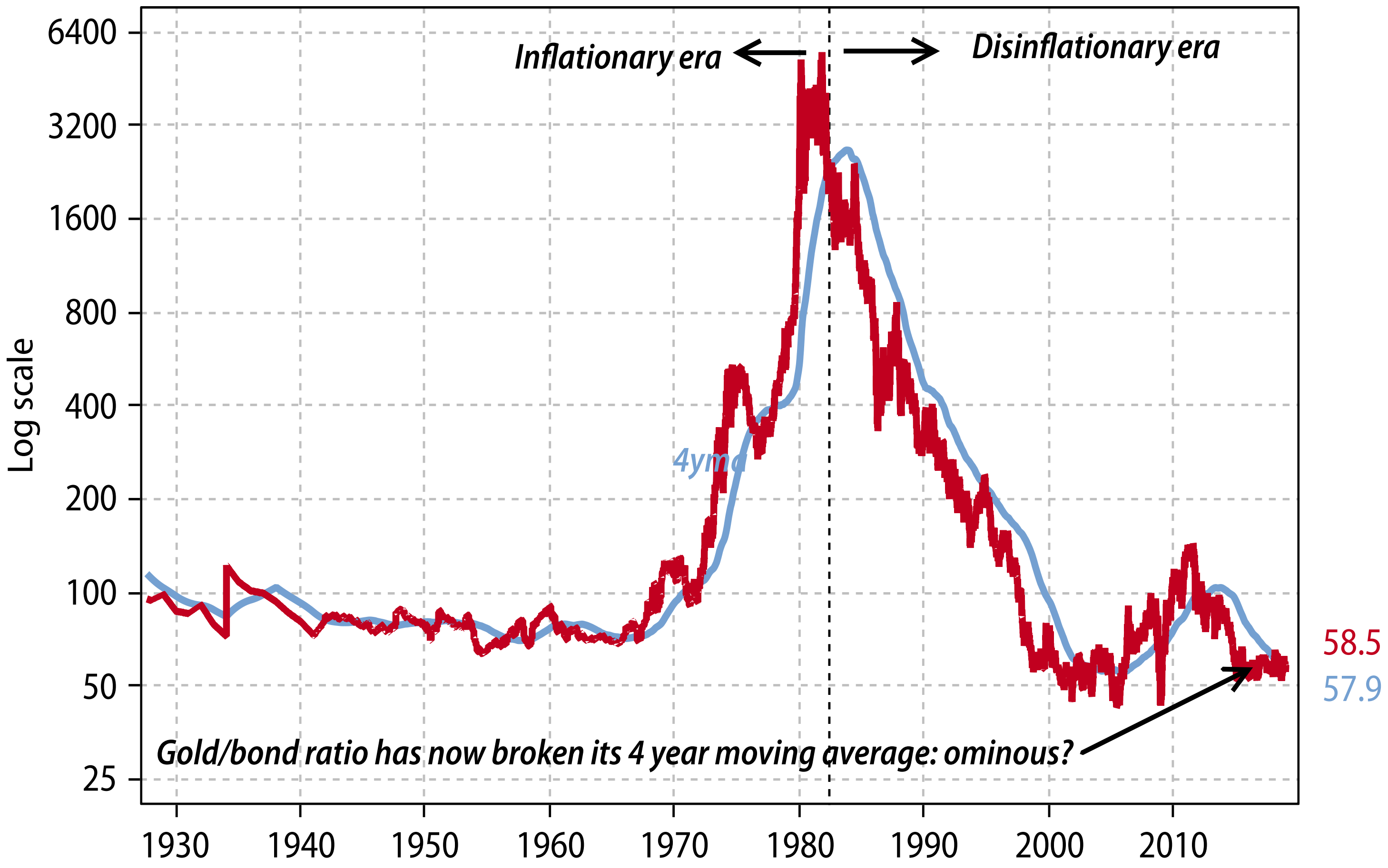
Will Fed defend bond markets & USD? Or will the Fed defend equity markets?

The gold/bond ratio just broke its critical threshold

Gold price / long-dated treasuries (total return)



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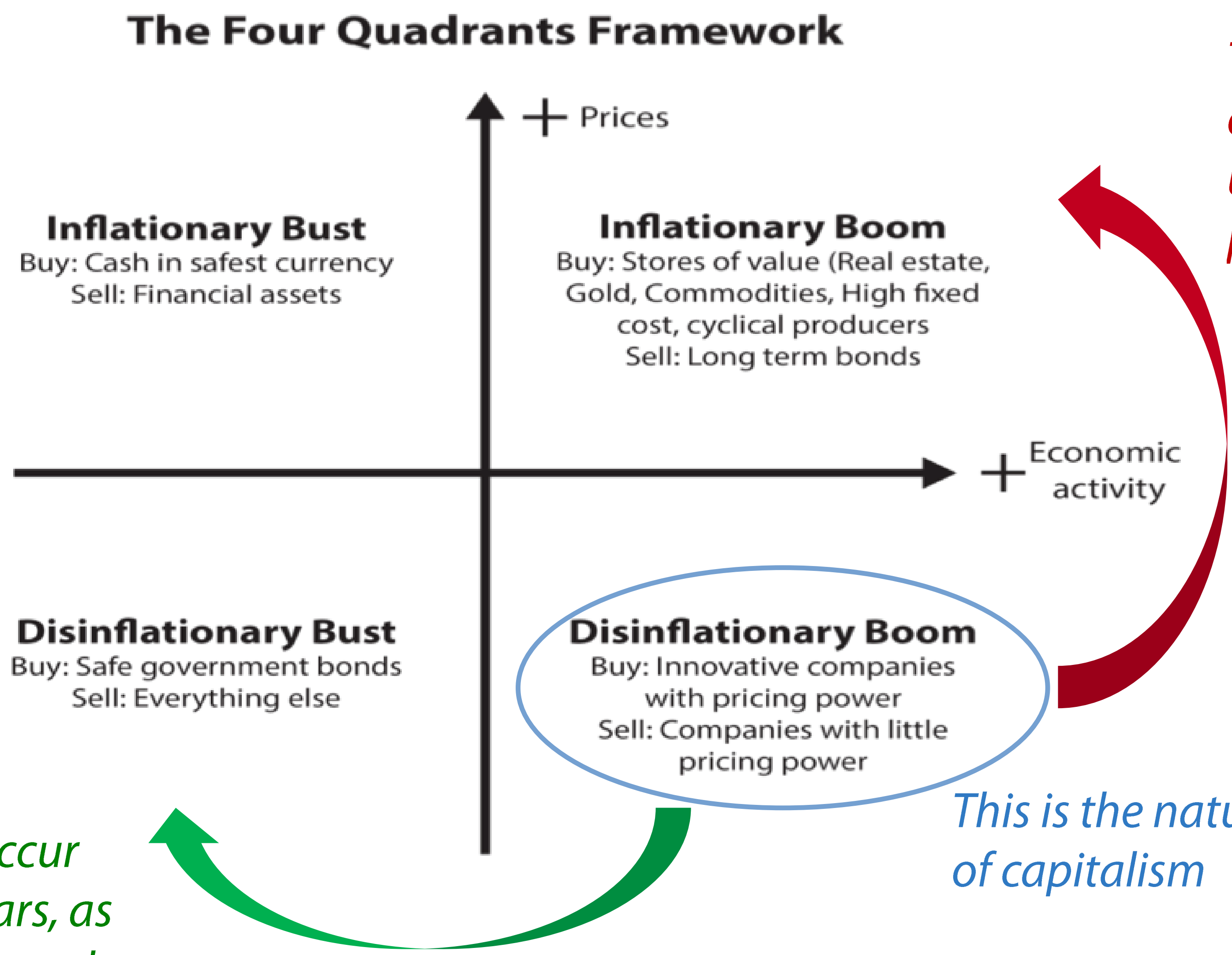
- Gold has no yield, the bond market does. If over a long period (4 years) gold outperforms the total return on bonds, inflation (or inflation expectations) is rising. ***Investors are willing to abandon a nominal return for a speculative capital gain on gold.***
- Once the ratio breaks through its 4yma, it tends to trend in that direction. Today we have just broken the 4 year moving average. **Conclusion: we could be witnessing a structiral shift to inflation.** (See ***A 'Once In A Generation' Shift***.)

Would an easy fiscal/easy money mix mean the end of the deflationary era?



These shifts occur every 30-40 years, usually because of policy mistakes

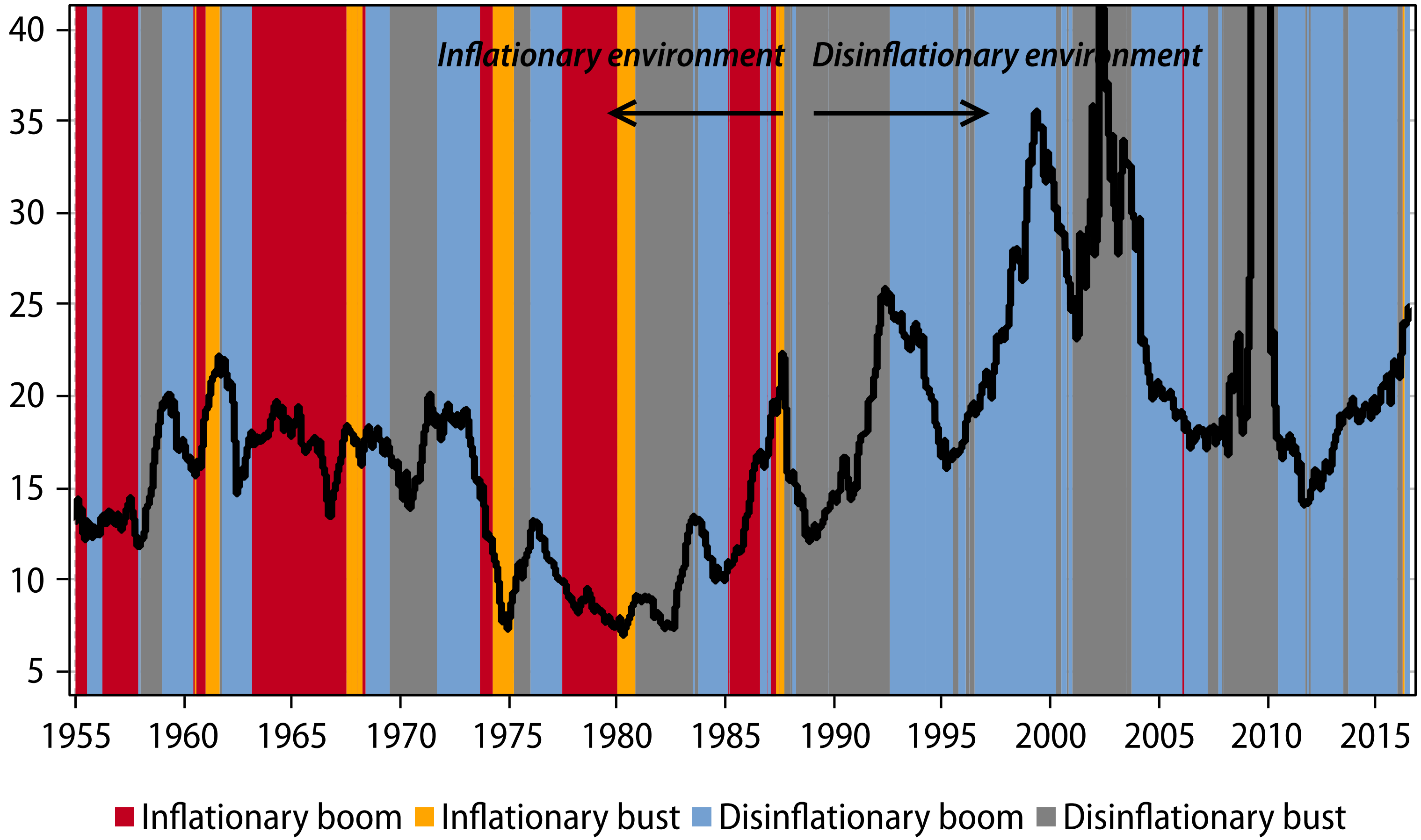
This is the natural state of capitalism

These shifts occur every 7-10 years, as part of the normal business cycle

A different investment environment: disinflation has been norm since 1980s

The end of a disinflationary era?

S&P 500 P/E ratio & the four quadrants



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From the 1950s through the mid-1980s, the US was in an inflationary environment more often than not (red and orange bars). Since the late 1980s it has been almost continuously in disinflation territory (blue and gray bars). Equity valuations do best during disinflationary booms.

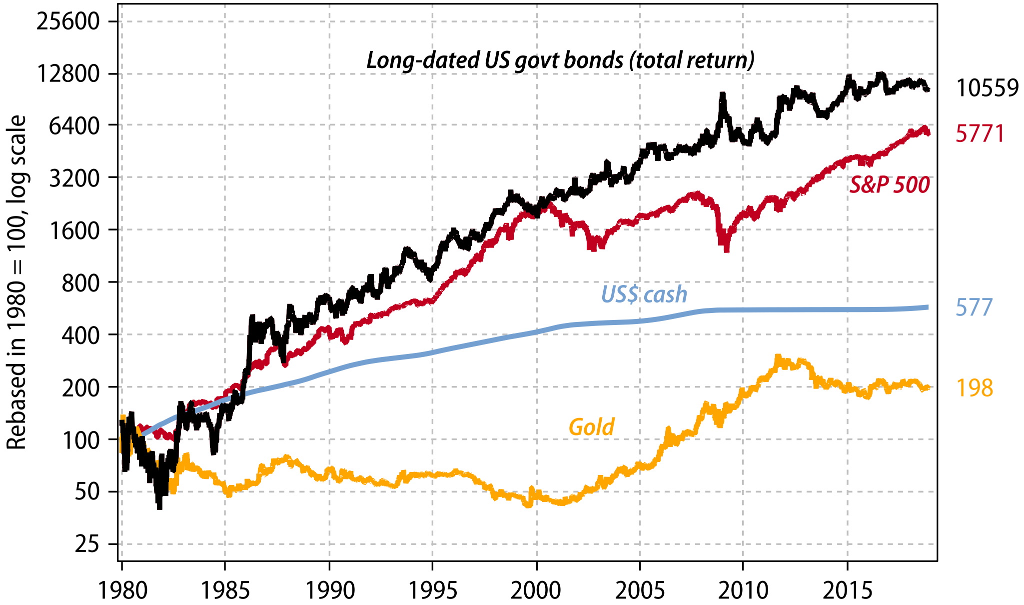
In disinflationary times the ideal portfolio is 50% long bonds and 50% aggressive growth stocks.

In inflationary times, value stocks, commodities offer the best value during booms, and should be hedged with cash and gold.

Bonds have not diversified in this downturn: has environment already shifted?

In disinflation, long bonds offer the superior hedge

S&P 500, US long bonds, gold & US$ cash in a disinflationary period



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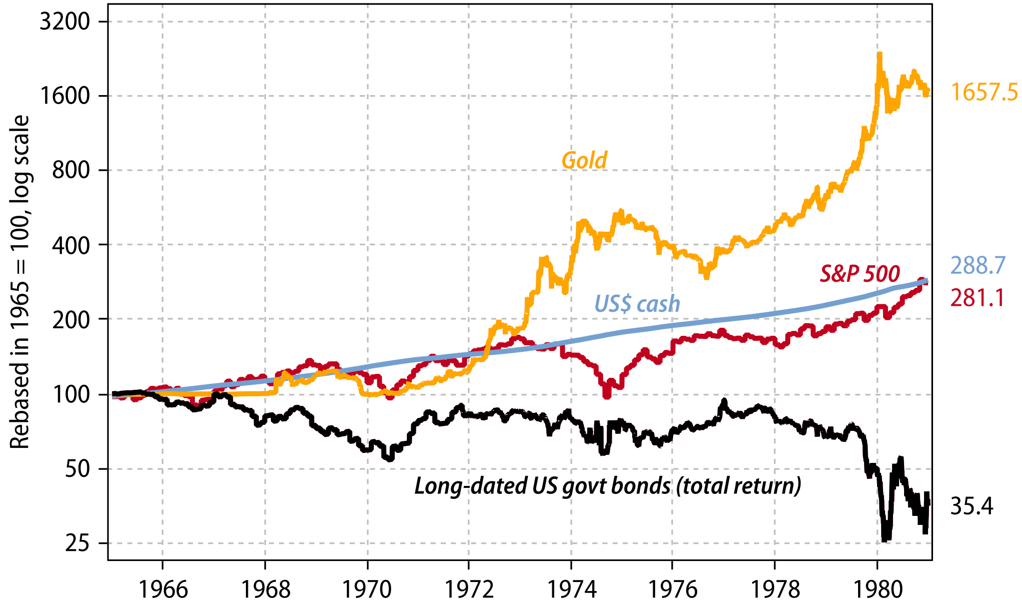
During inflation, the best hedges are cash and gold

S&P 500, US long bonds, gold & US$ cash in an inflationary period



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Since 1980, a broadly disinflationary environment has meant that long-dated US government bonds offered the best hedge, outperforming even the very strong stock market returns.

Cash and gold substantially under-performed.

But in the inflationary 1960s and 1970s, long bonds did terribly, and equity portfolios were best hedged with gold and US-dollar cash.

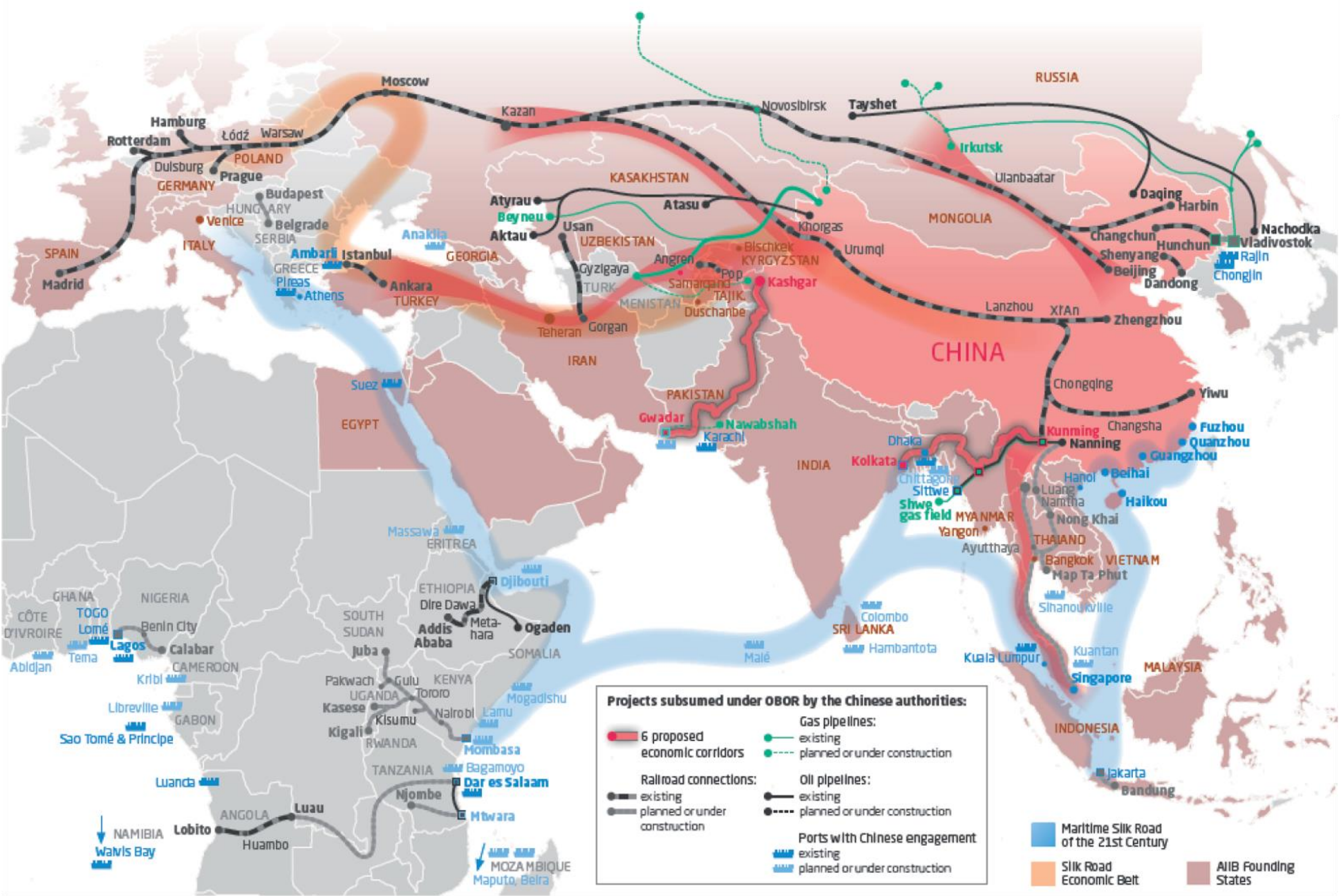
So a crucial question for money managers is whether we are making a secular shift from a disinflationary to an inflationary era—thereby requiring a change to the defensive component of the portfolio.

4- The 'structural' explanation: the end of ChinAmerica & China's counter punch on the US$

Everyone focuses on the US, assuming that China will be a "taker" of deal

- Most investors focus on the US to see what the US will do next. **The inherent assumption is that China doesn't have many cards to play.**
- Meanwhile, in China, what have we seen of late?
    1. Tepid responses to US overtures
    2. Massive imprisonment of Uighurs in Xinjiang
    3. Imprisonment of A by-product of Meng Hongwei (Interpol chief), one of a few Chinese officials heading an international organization
    4. Crackdown on churches
    5. Refusal of a HK visa for a Financial Times journalist
- **Maybe China should instead arrest the Minister for Propaganda? Or is China actually looking for bad press?**
- **More importantly, if China now sees itself in a long-term struggle with the US, don't expect China to come to the rescue of global growth as it did it 2008 and 2016.**

OBOR: a grand strategy of imperial roll-out



Source: Mercator Institute for China Studies

“Made in China 2025” – large scale industrial ambitions

- “**Made in China 2025**” is a broad industrial policy with many goals:
  - ✓ Improve manufacturing productivity by better use of IT
  - ✓ Develop capacity/leadership in many tech-intensive sectors (AI, robotics, new-energy vehicles, semiconductors, etc.)
  - ✓ Import substitution: 70% domestic self-sufficiency in “basic core components and important basic materials” by 2025

- “**Made in China 2025**” has some massive funding behind it:
  - ✓ US$232bn spent on R&D in 2016, with nearly 80% by companies
  - ✓ Government venture funds: US$328bn in capital (1/3 for ICs)
  - ✓ Private funds: US$100bn in venture capital; US$1.2trn in private equity

- The Central Commission for Integrated Military and Civilian Development (founded in 2017) raises fears that much Chinese tech development—especially AI—will be turned to military use.

Why did Xi Jinping throw down the gauntlet?

Xi throws direct challenge to US imperial hegemony

Option 1: *Xi is stupid/blinded by too much power/misread US political divisions as weakness*

Our take: *unlikely*

Terrible news for all Chinese assets as China will now feel the full wrath of US fury.

Option 2: *Xi bet that the US is a paper tiger whose main comparative advantage is reserve currency*

Our take: *possible*

Next phase of the battle will be over the US$, which will either soar, or collapse…

Option 3: *Xi assumed that China held key advantages in the new imperial battle-lines, namely over telecom roll-out*

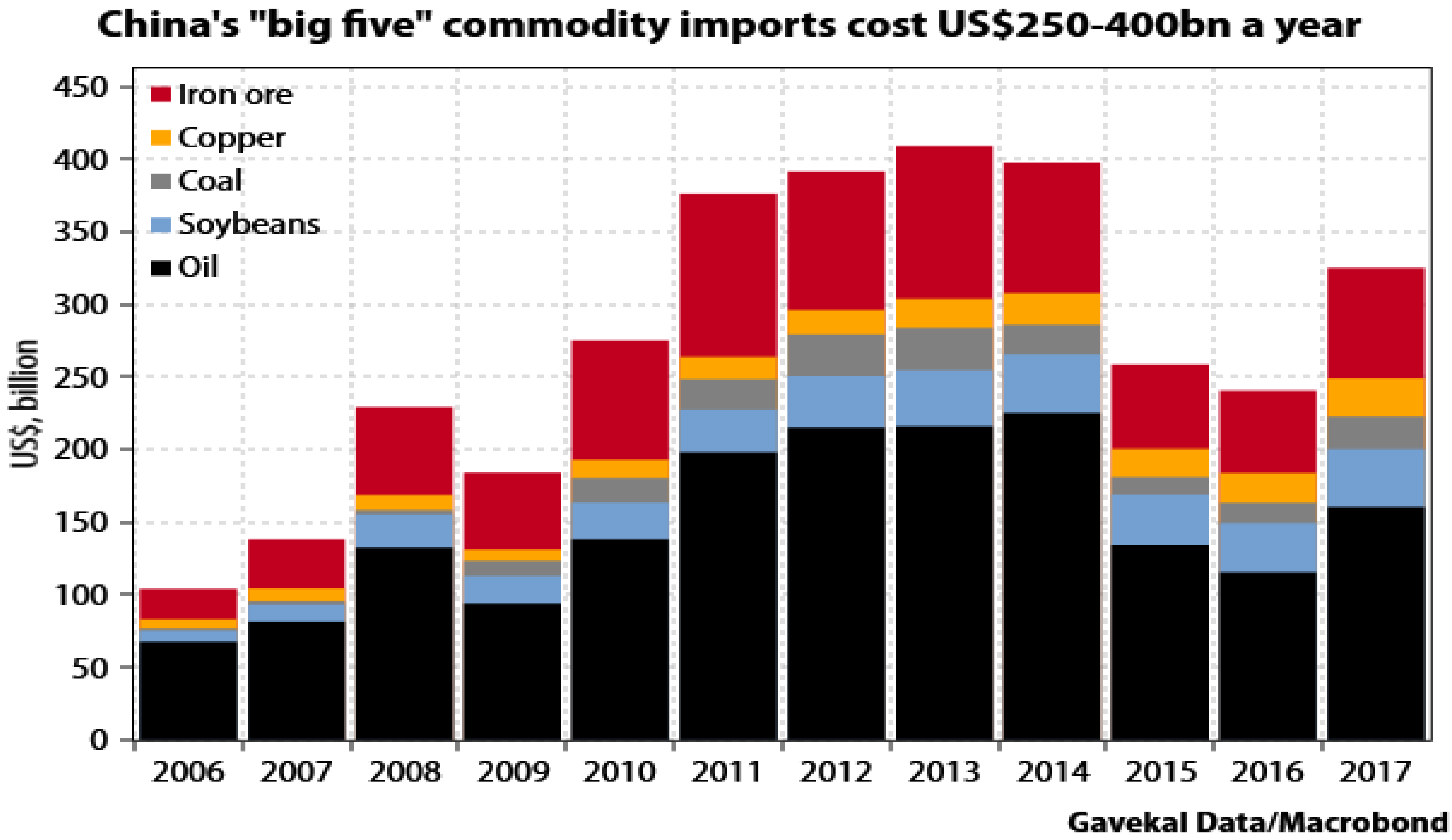
Our take: *likely. But US is now pushing back hard. Huawei is this century's Suez Crisis*

This would be a rather bearish development. Perhaps not surprising that markets have been tanking since Huawei .

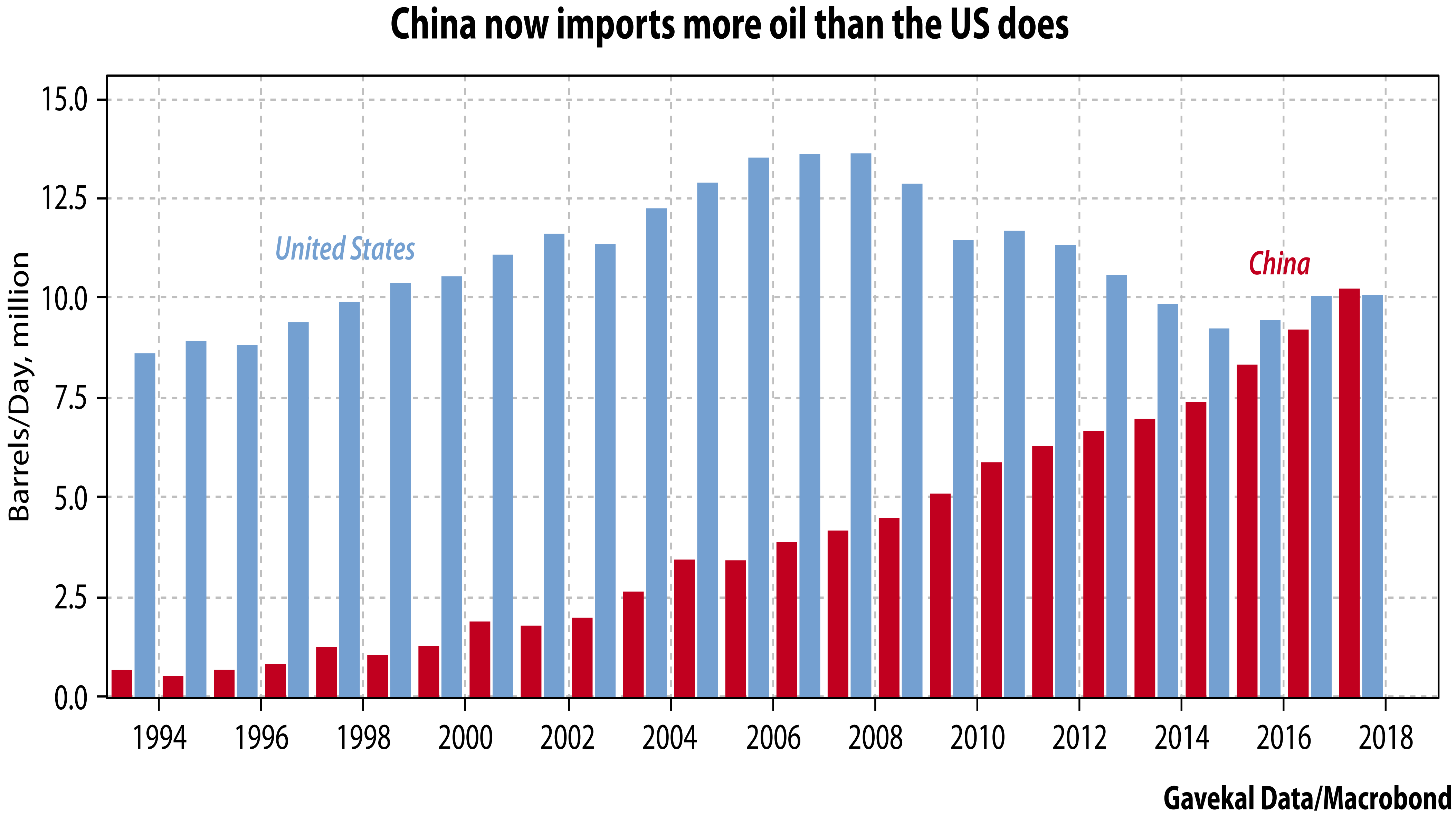
What if Xi Jinping has decided that now is the time to strike?

- Given China's imperial ambition, **it is not a question of whether China will need to challenge the US$' reserve status, but a question of when**.
- Xi jinping, and the broader Chinese leadership, most likely know that for China to attempt to de-dollarize Asian trade, and de-dollarize the commodity trade, can not happen without some crisis, and some pain.
- Thus, our assumption was always that, like St Augustine, the Chinese leadership would always look to 'rise to the challenge' at some point far into the future.
- **However, could recent events have convinced the Chinese leadership that, given the growing anti-China sentiment in Washington, the "when" is now?**
- **Or even perhaps that the "when" is now because the US is a 'paper tiger'? Or simply because the US president today is somewhat unpopular at home and abroad?**

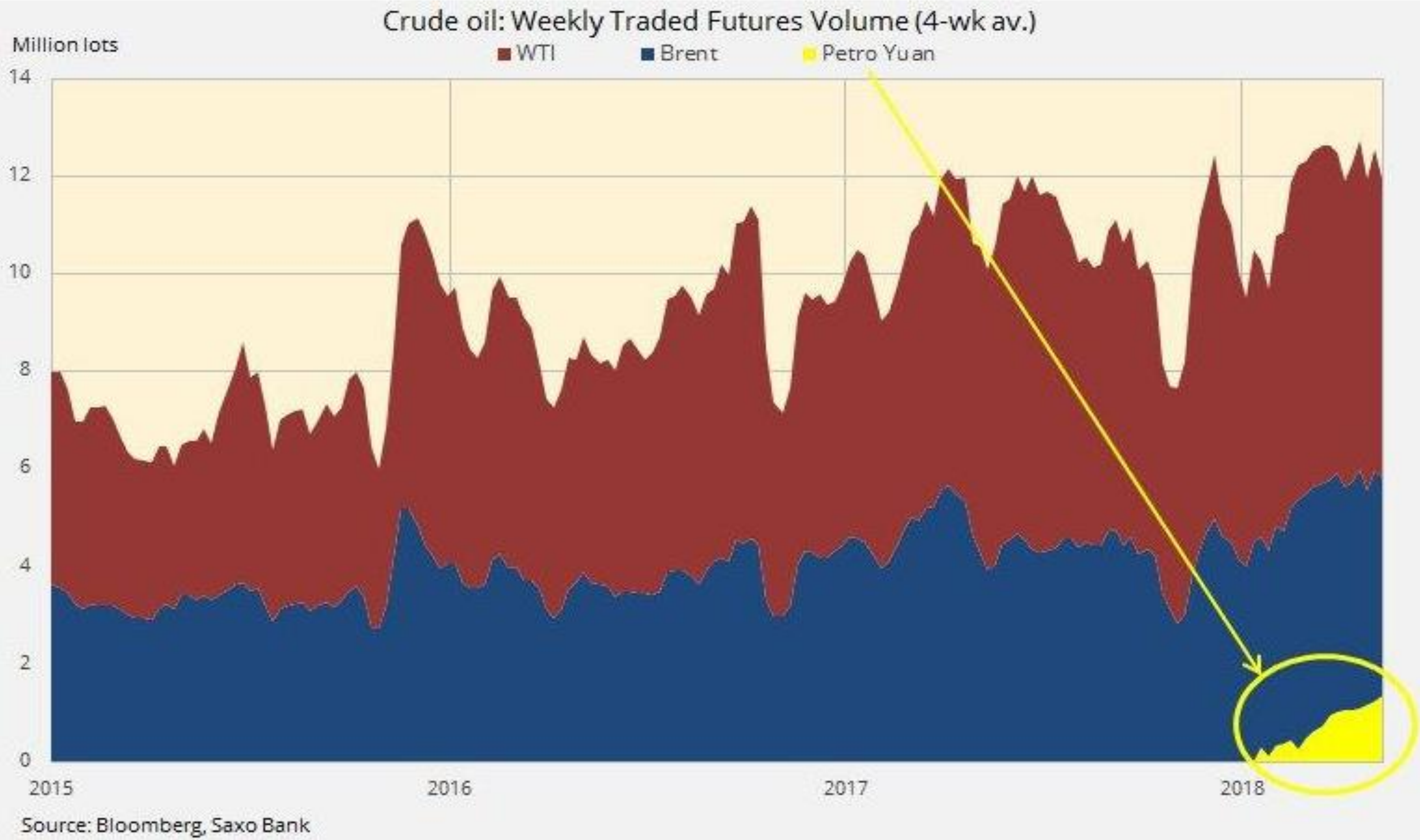
You can't build an empire on someone else's dime



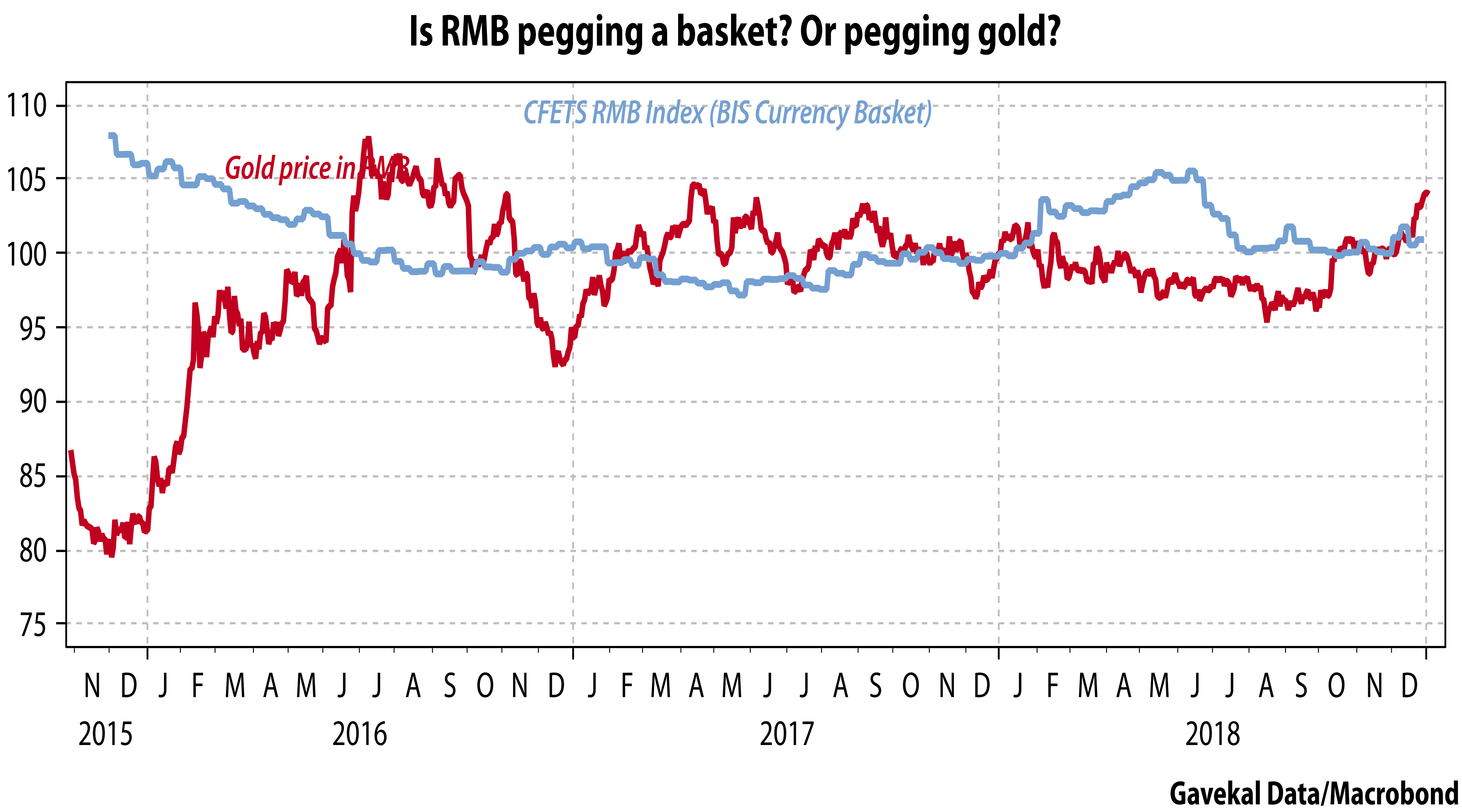
If the US no longer wants to export US$, how will China pay for its oil?



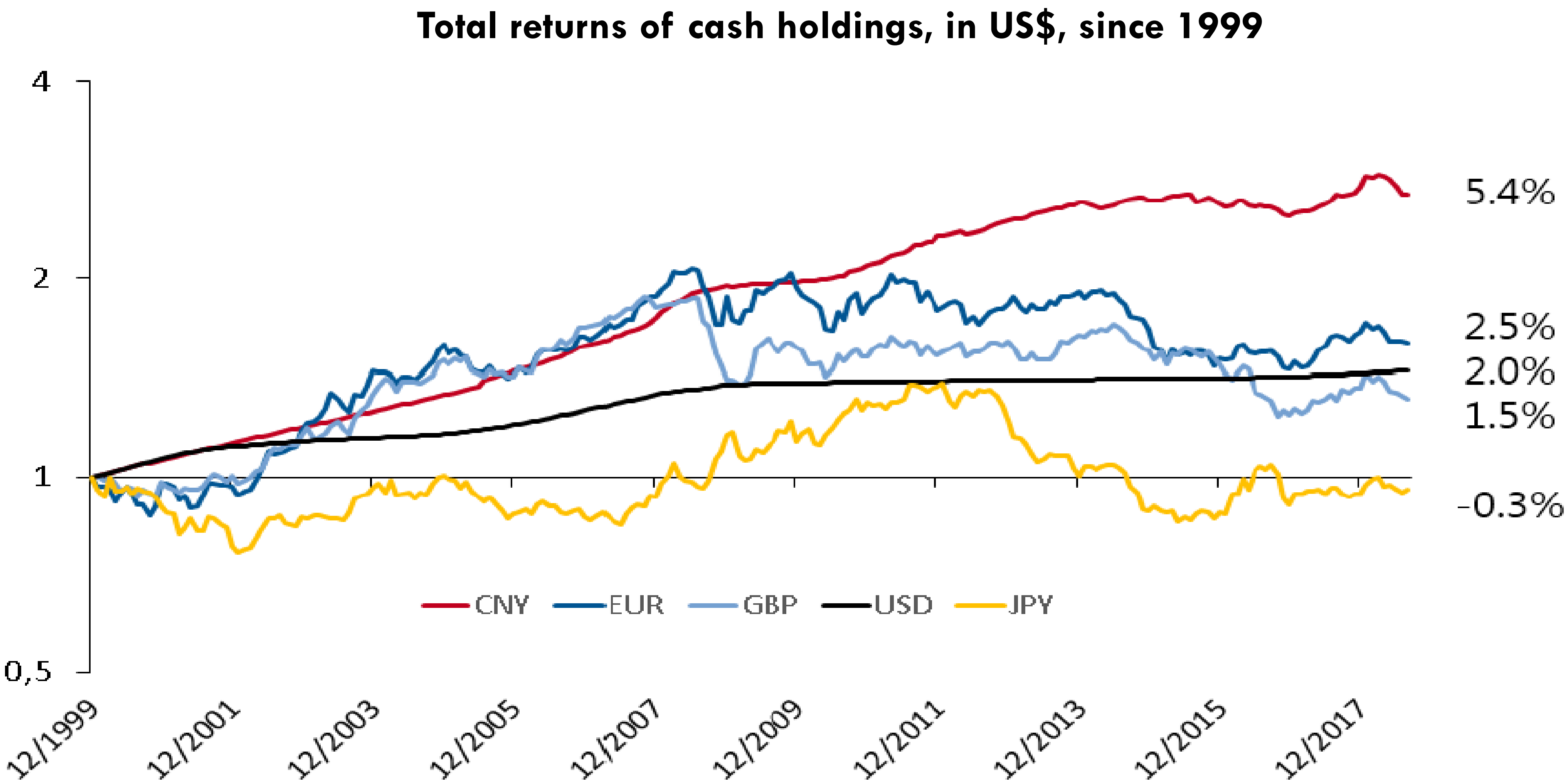
China is clearly attempting to de-dollarize commodity markets



Why has the gold price in RMB been so stable?



To shift Asian/commodities trade away from US$, RMB needs to be credible



Source: Blomberg data 31/12/1999 to 31/08/2018

And bond market needs to offer superior returns

Evolution of a US$100 invested in 5 year govt bonds in 5 year CGB and UST

Gavekal Data/Macrobond

- If the pattern of the past five years is maintained, UST should soon start outperforming RMB bonds.
- **Given yield differentials, this can only really happen through a stronger US$. But how will the US$ get stronger when:**

i. A global equity meltdown does nothing to value of US$
ii. Dovish words from ECB and BoJ have no impact
iii. Stronger US growth and US inflation do nothing
iv. Hawkish Fed has no impact?

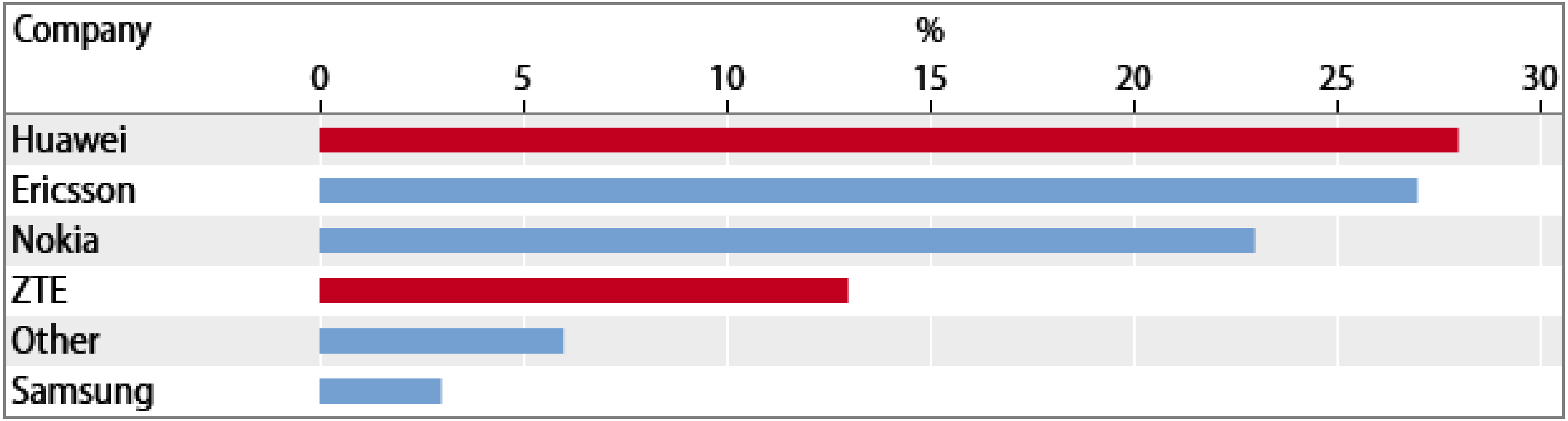
- **Maybe through a trade war?**

5- Controlling the new “sea-lanes”

What is more valuable: control of sea-lanes? Or control of telecom lines?

In 2017, Huawei overtook Ericsson as the top global vendor

Mobile infrastructure market share in 2017



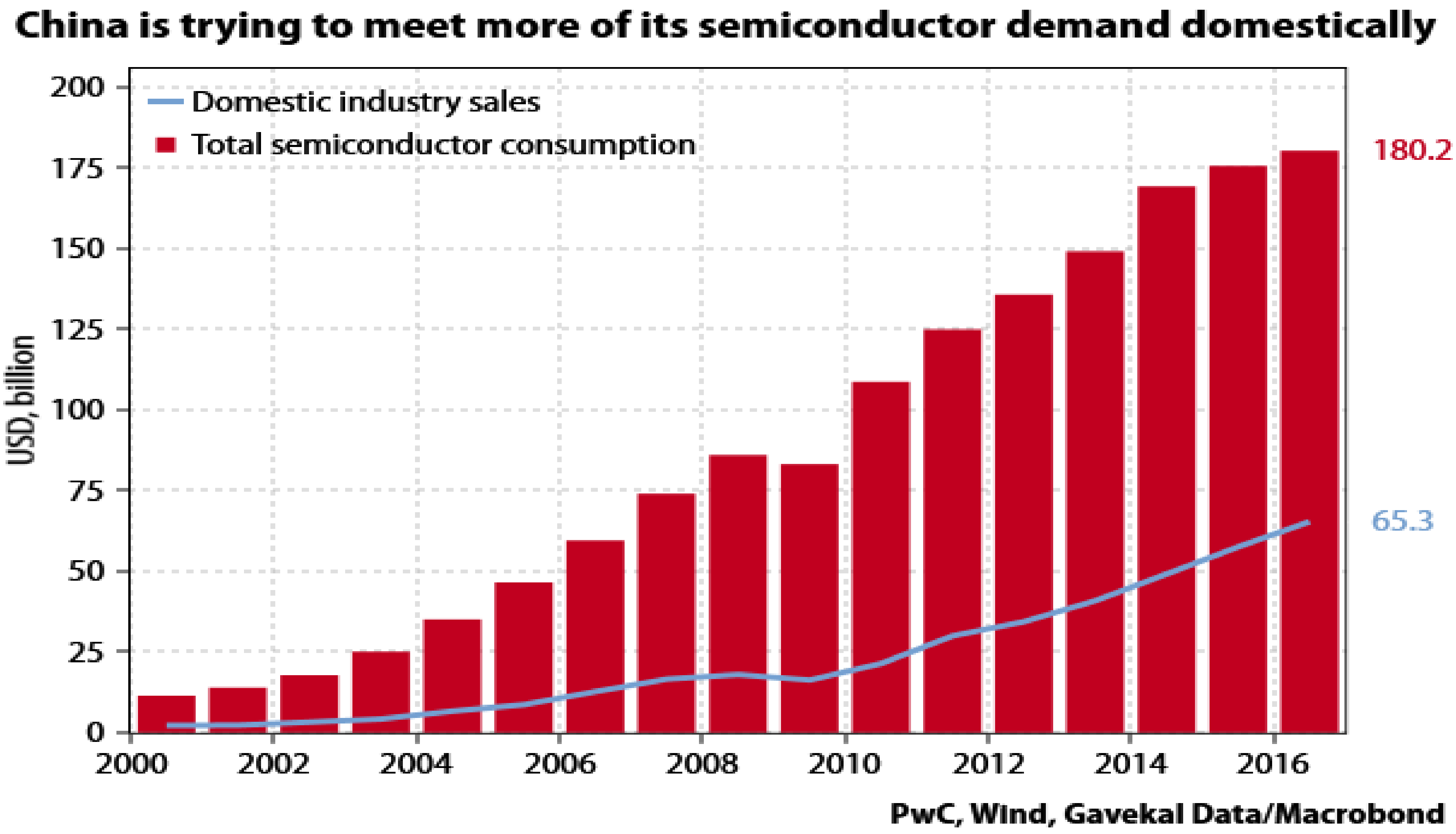
IHS Markit, Gavekal Data/Macrobond

ZTE and Huawei are this century's 'Suez Crisis'

Market Capitalization of ZTE

Gavekal Data/Macrobond

If you were China, how would you react?



China is now pouring money into semiconductors

New domestic players are taking on the foreign incumbents

Memory fabrication plants in China

Company	Location	Operational	Investment
SK Hynix	Wuxi	2005	US$5.5bn (+$800mn 2016 expansion)
Samsung	Xi'an	2014	US$7.5bn (+ US$7bn 2017 expansion)
Intel	Dalian	2016	US$5.5bn
Yangtze Memory Technologies Corp. (YMTC)	Wuhan	2018 (planned)	US$24bn
Tsinghua Unigroup	Nanjing	2018 (planned)	US$30bn
Jinhua Integrated Circuits Co. (JHICC)	Quanzhou	2018 (planned)	US$5.7bn
Innotron Memory	Hefei	2018/9 (planned)	Unknown

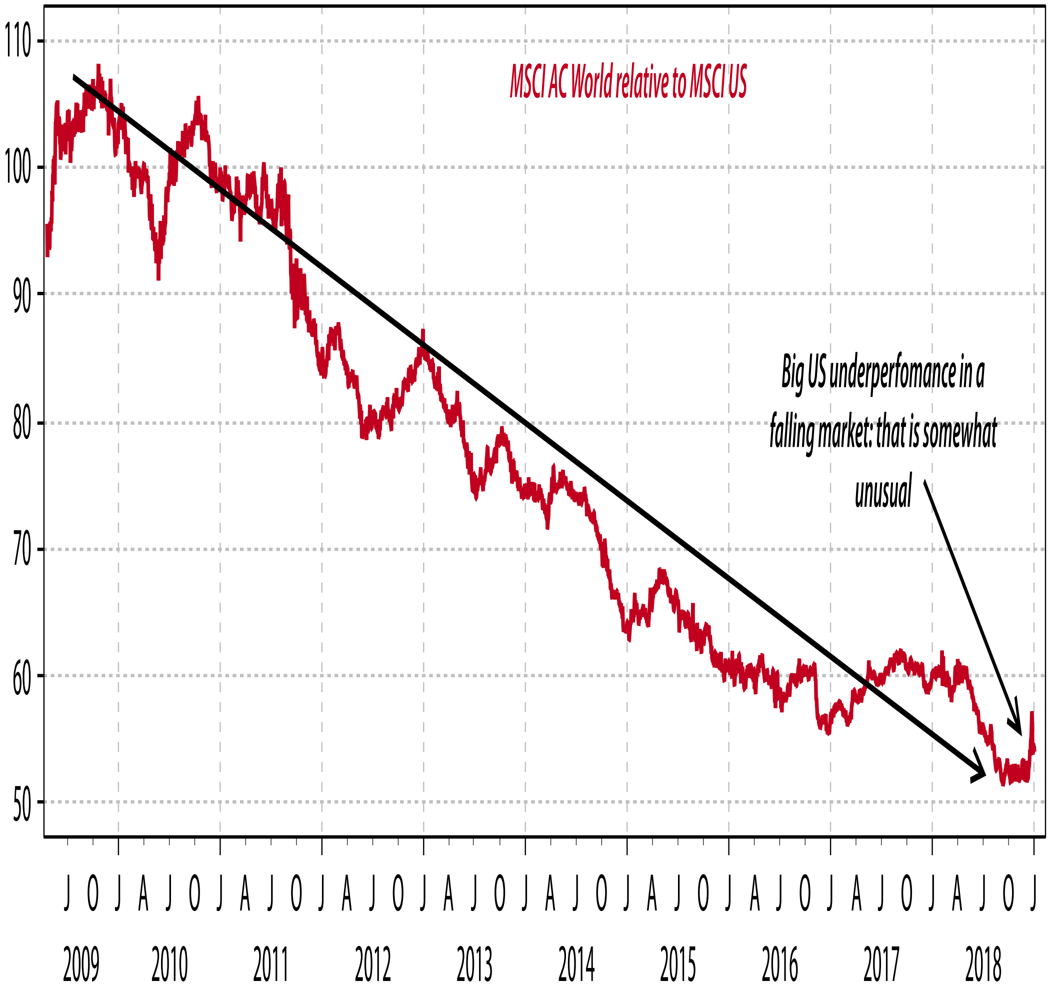
SEMI World Fab Forecast, Credit Suisse, Gavekal Dragonomics

Who wins and who loses in this telecom war?

- A "telecom war" with the semis as the main weapon could be very bearish for the US$. After all, if the US runs a large current account deficits, and the foreigners who earn these US$ are told "*we get to choose what you can, and can not buy with these US$*" when they try to buy US goods or US assets, then the foreigners will likely conclude '***so what are these dollars good for then***?". In essence, this would be a repeat of the 2002-07 US$ bear market (when the Dubai Port deal was blocked etc…).
- **If the battle-line of the new Cold War is telecoms, and the weapon of choice is semis,** then this will be very bearish for semis (as excess capacities are built across the system) but perhaps bullish on US telecom suppliers like Cisco or Arista as these will start to benefit from US government largesse?
- A weaker US$, weaker growth, world would mean that BoJ and ECB would likely maintain their NIRP policies for years to come. **This would be bad news for European and Japanese financials.** However, the continuation of NIRP in Europe and Japan would be good news for high dividend yielding stocks in markets across the Globe.

Are we living a shift in the investment environment/

Through this decade the rest of the world has underperformed the US...



Gavekal Data/Macrobond

...and in the US, value stocks have underperformed growth stocks

Gavekal Data/Macrobond

An important shift has started to occur in past quarter

- Financial theory teaches that, in order to determine the price of an asset, we should take its foreseeable future cash-flows, discount them by a risk-free rate to which we can add a risk premium, and then beyond these cash-flows ascribe a “residual value” to the business. Until a few months ago, the market in its infinite wisdom, had decided that:

1. **Near term cash-flows didn’t matter.** So you could have companies in the energy space or the consumer staples space, or even plain old boring utilities, that delivered beautiful cash-flows but which were worth little compared to the likes of Tesla, Uber, WeWork and other cash-flow-burning entities.

2. **This was because there were sectors**—energy, autos, electric utilities, mass produced consumer goods—**where residual values were worth zero**. After all, who will still need oil in ten years? Or who will still be driving a car powered by an internal combustion engine? Or whose house will not be self-sufficient in energy? Meanwhile, other sectors had massive potential residual values.

- As a result, the last decade has been characterized by a twin split in the market. Firstly there has been a split between the US, where most of the companies with massive potential residual values are located, and the rest of the world. And secondly there has been the performance split between “growth stocks”, which were typically ascribed massive residual values, and “value stocks”, whose residual values were assumed to be either close to zero or even negative (for example because of the weight of unfunded pension funds, *à la* General Electric.

- **Is this split now coming to an end?**

Three competing tech models to deal with disruption

- **The "Apple" model:** bet the farm on a few products that correspond to the vision of a brilliant founder/CEO.

- **The "Facebook" model**: Use one's shares to buy out promising companies and integrate them within one's eco-system (Whatsap, Instagram, Oculus…)

- **The "Amazon" model:** Launch lots of new products (Kindle, Prime, TV, Alexa,…) and see what sticks.

Today, the first two models are deeply challenged. And this has triggered a shift in the investment environment.

6- Investment conclusions

Forget "ChinAmeria", world will now have three distinct monetary zones

	Americas	Europe	Asia
Reserve Currency	**US$**	**Euro**	**RMB**
Comparative advantages	Technology leader Weapons leader Education leader Energy US$ reserve currency	Quality of life Accumulated wealth Manufacturing knowledge	Cheap labour Telecoms knowledge Genuine tech sector High savings rate No welfare state
Monetary policy outlook	Tighter	Tighter	Easier
Fiscal policy outlook	Easier	Easier	Easier
Growth outlook	Slowing	Slowing	Slowing
Equity Valuations	Fair	Attractive	Attractive
Govt Bond Valuations	Expensive	Very Expensive	Fair
Investment consequences	***As the bull market stumbles, US equities have lost the leaders' mantle. This will likely be bearish on the US$. UNDERWEIGHT***	***Europe moving to tighter money/easy fiscal. That's the worst combo for asset prices. That plus political uncertainties and only argument for Europe is Value. UNDERWEIGHT***	***Few investors own RMB bonds, or cash, even as currency's role in the future looks set to grow. And with reduced dependency on US$, cycles should be tamer. OVERWEIGHT***

"Structural Growth" Themes

- **Telecom infrastructure**: combine the rollout of 5G infrastructure and the growing tensions between the US and China over who will get to control the telecom lines, and it seems likely that the US government will help companies like Cisco, Arista etc…
- **Videogames**: after the crypto currency bubble, after the marijuana bubble, will videogames be the next big thing? Target audience is similar, games are increasingly addictive and of course massively scalable. Booming use in countries like China, India, Philippines etc…
- **Medical devices**: combines both growing demand from ageing developed markets and booming emerging markets.
- **Batteries:** the future is likely to be one of electric cars and 'off-grid' houses…
- **Diabetes**: as diets change across the emerging world, diabetes rates will continue to soar
- **Chinese bonds**: no-one owns them and Chinese bonds still offer modicum of yield. Over time, Chinese bond yields will move below those of US bonds and this will likely happen with a stronger RMB.

"Contrarian" Themes

- **Gold**: a hedge on many possible negative scenarios. But perhaps most importantly, gold has behaved rather well in the past few months' of broad asset sell-off.
- **Energy producers**: with oil below US$50/bl, capex in the oil space (which was already very low) is likely to collapse even further. This should put a floor under oil prices and leave large oil producers in a strong cash-flow generating situation.
- **Mexico**: AMLO's arrival has led to a de-rating of assets. The Peso is also now very cheap. Meanwhile, Mexico would be a beneficiary of any further deterioration in the US-China relationship.
- **Argentina & Turkey:** this summer's two 'red-headed step-children" have been given an important respite through falling oil prices. A falling US$ could provide further boost to beaten up asset prices…
- **Brazil**: Bolsonaro's election is boosting animal spirits in Brazil in a manner reminiscent to the bull market that followed Trump's election in 2016. Foreign investors remain very sceptical (or un-interested) but local investors are unlikely to sell…
- **Long Italy/Short France bonds**: As Salvini rides high, Macron has now lost the ability to pass any reforms. Hard to understand the massive spread between the two countries.

“Defensive” Themes

- **Airports**: Airports are one of the few assets around the world that are likely to still be around in 30 years time. Better yet, most airports continue to register steady traffic growth as more and more people travel. Yet, most airports are not that expensive and offer solid dividend yields.

- **Waste Management & Environmental recycling**: as the value of components in everything we produce continues to rise, recycling and waste management become increasingly value-additive to the system. Perhaps more importantly, they are seen as such by a growing number of governments who are keen to reward these behaviours.

- **US foodstuffs**: An easy way for China to give Donald Trump a “big win” is to increase massively purchases of US foodstuffs.

- **EM debt:** Emerging market debt has now sold off and typically offers attractive valuations, without all of the fiscal challenges confronting Western welfare states. More importantly, as the US$’ role starts to diminish, then EM debt should become less volatile.

- **MLPs:** US MLPs have sold off in sympathy with the broader energy sector. But now yields are attractive and, unless we move to an oil/natgas free world, incomes seem

Contact and disclaimer

Thank you!

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TURNING THE SHIP
NAVIGATING DANGERS AHEAD

Andrew Jackson, Head of Fixed Income

8 January 2019

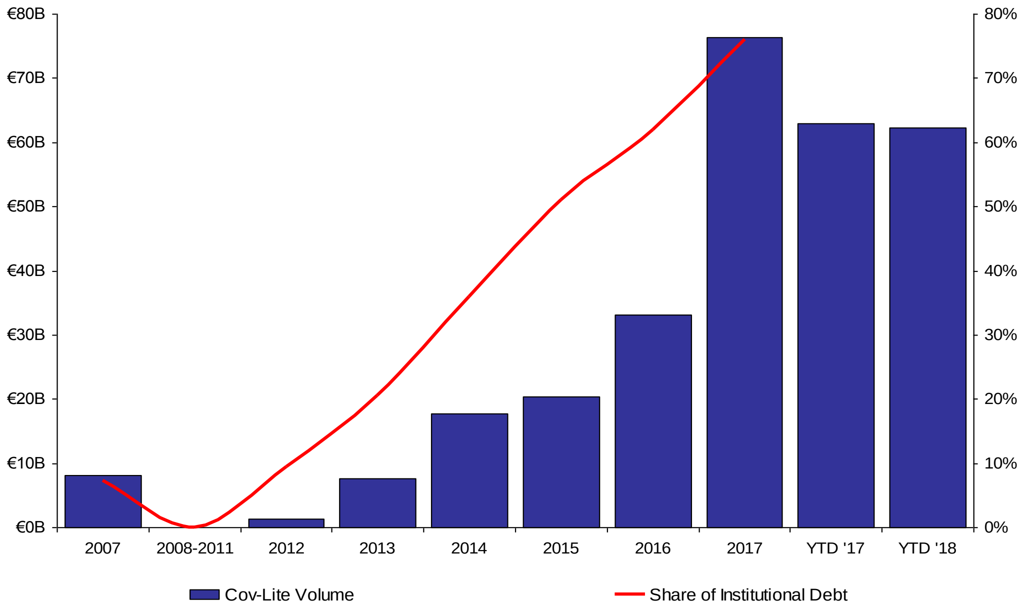
For professional investors only

HERMES INVESTMENT MANAGEMENT

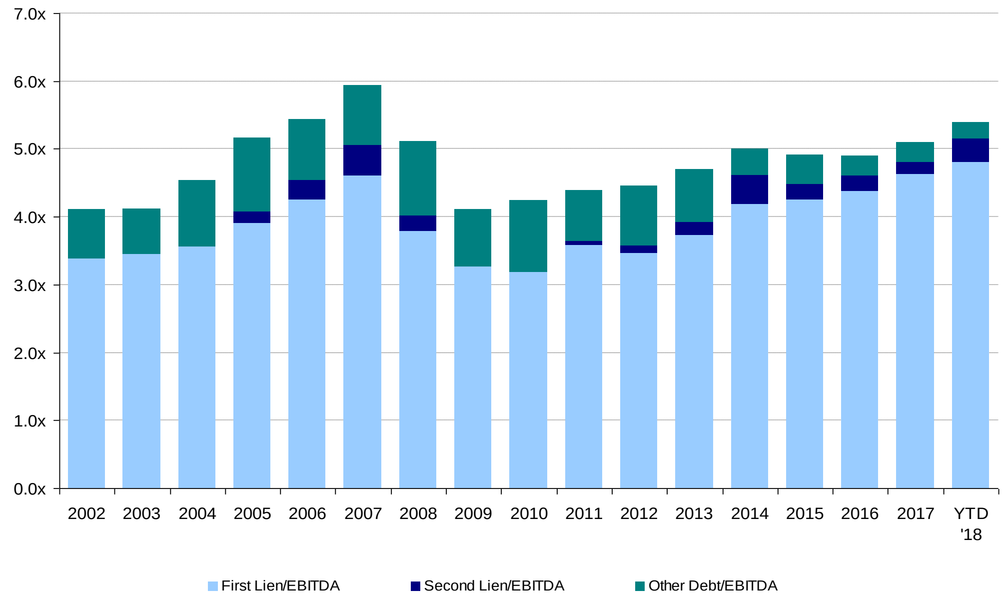
Market context

Credit conditions worsening – end of cycle?

Cov-Lite Institutional Volume: Annual



Annual Pro Forma Debt/EBITDA Ratios

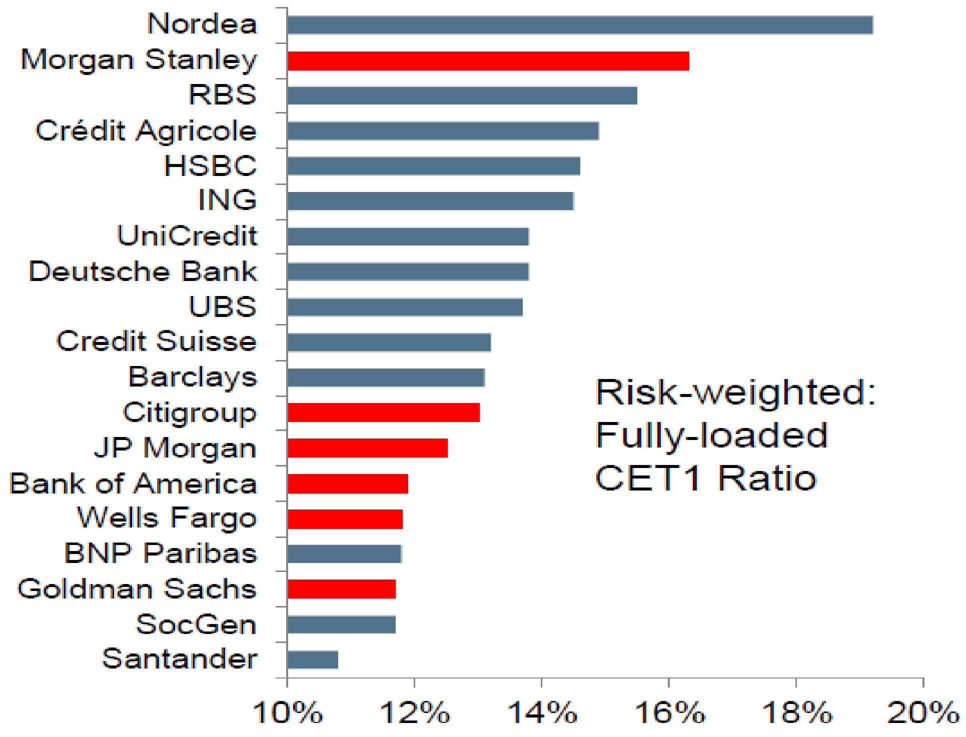


Source: S&P Global as at 30 October 2018. Copyright © 201*. S&P Global Market Intelligence (and its affiliates, as applicable).

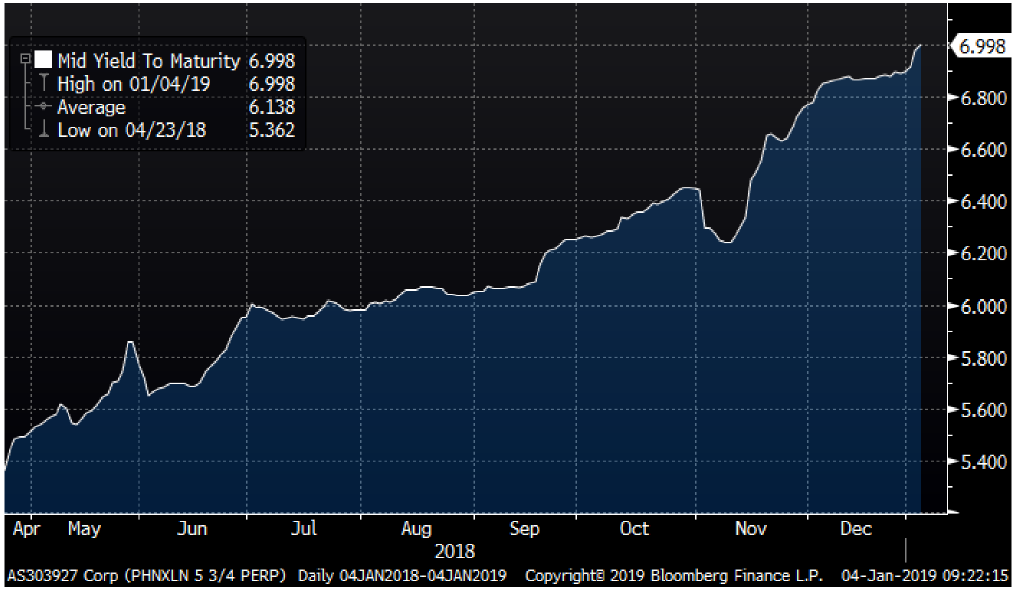
Market context

European Financials

Capital progression[1]



Brexit and Peripheral premia[2]

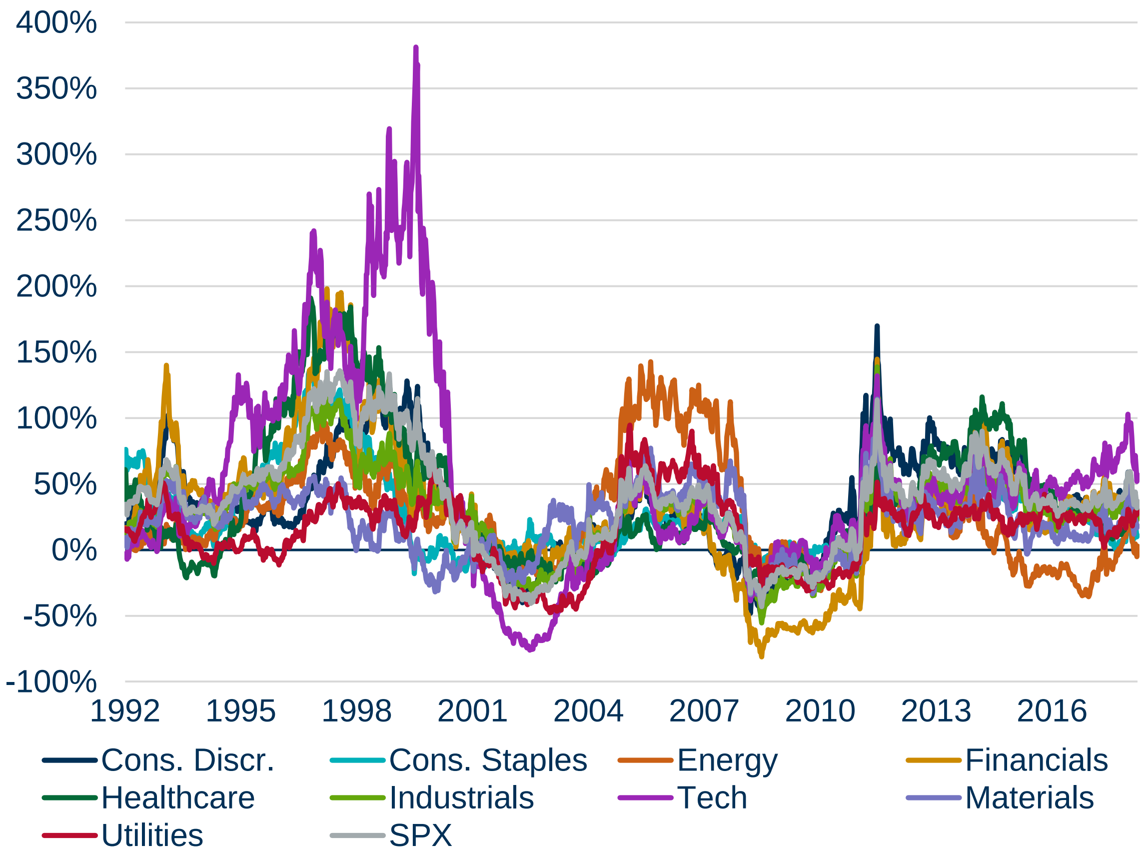


- Phoenix Group Tier 2 Perp issued in April
- Well capitalised UK specialty insurer
- Poorly understood and poorly covered
- Niche = illiquid and volatile

[1] Source: EBA, SSM, BoE, PRA as at end 2017. [2] Source: Bloomberg as at 4 January 2019.

Meanwhile in Equity land…

3 year rolling return[1]



Source: Bloomberg and Hermes as at 30 November 2018. [2] Bloomberg and Hermes as at 4 January 2019.

PE Normalisation[2]

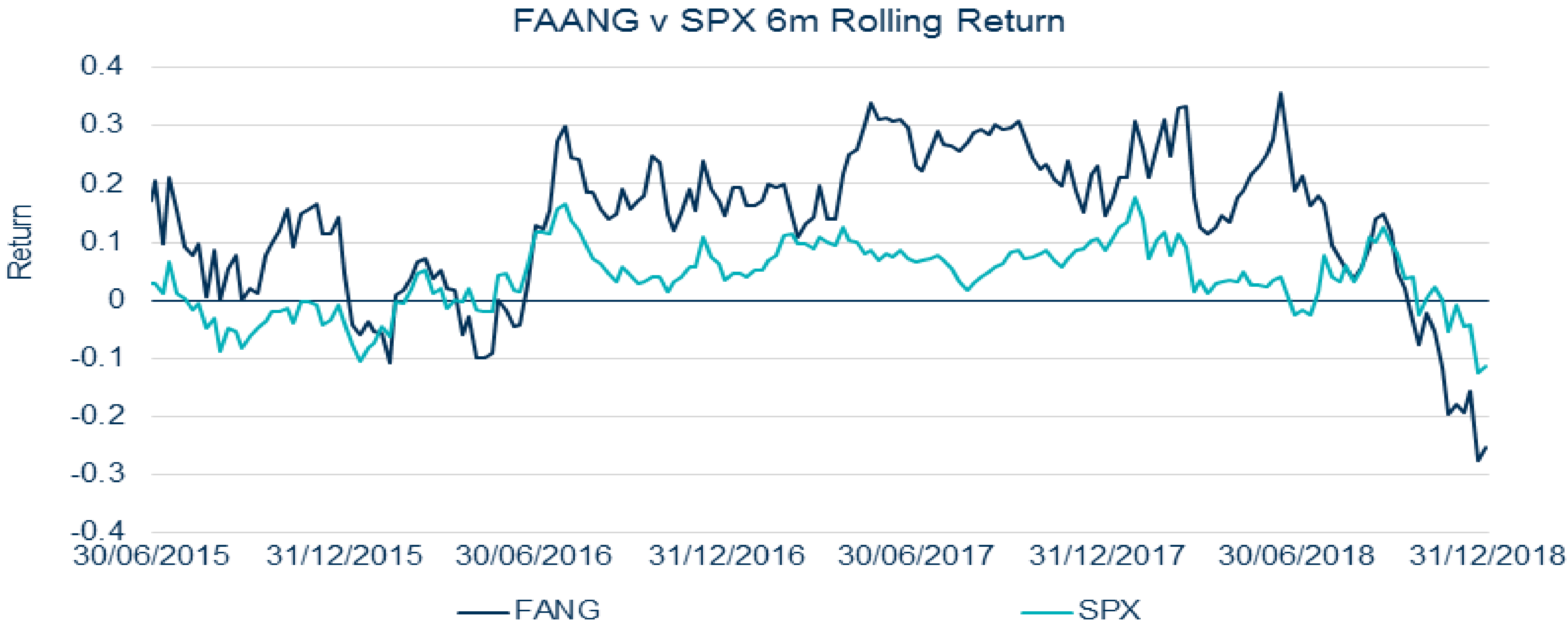
Long Run…

- Mean 15.73
- Min 5.31 (1917)
- Max 29.63 (1999)

HERMES INVESTMENT MANAGEMENT

Seeing positives in sell-offs

This is not irrational behaviour…

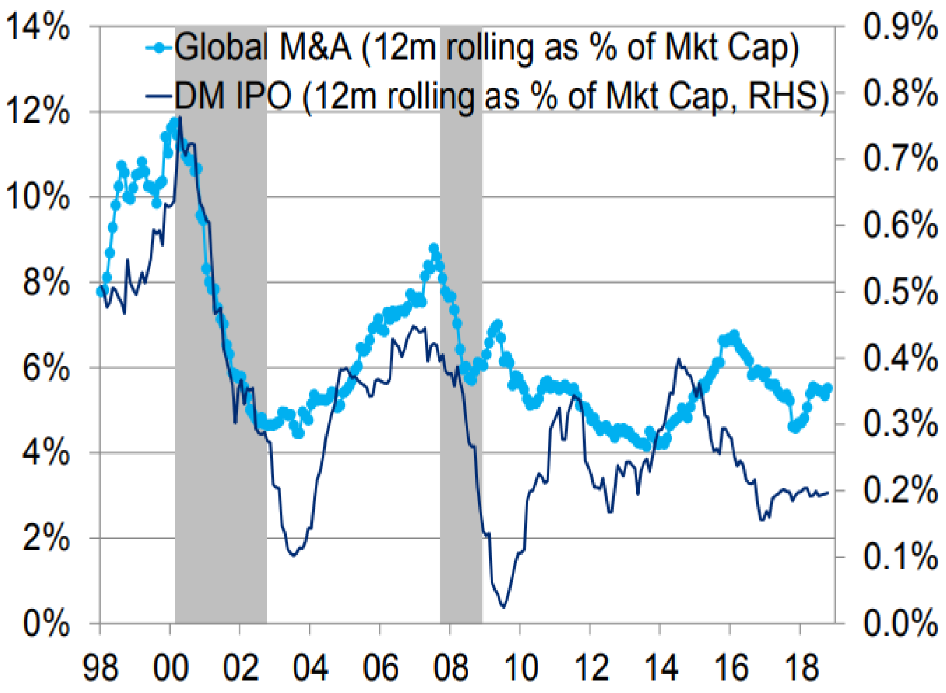


Source: Bloomberg and Hermes as at 31 December 2018.

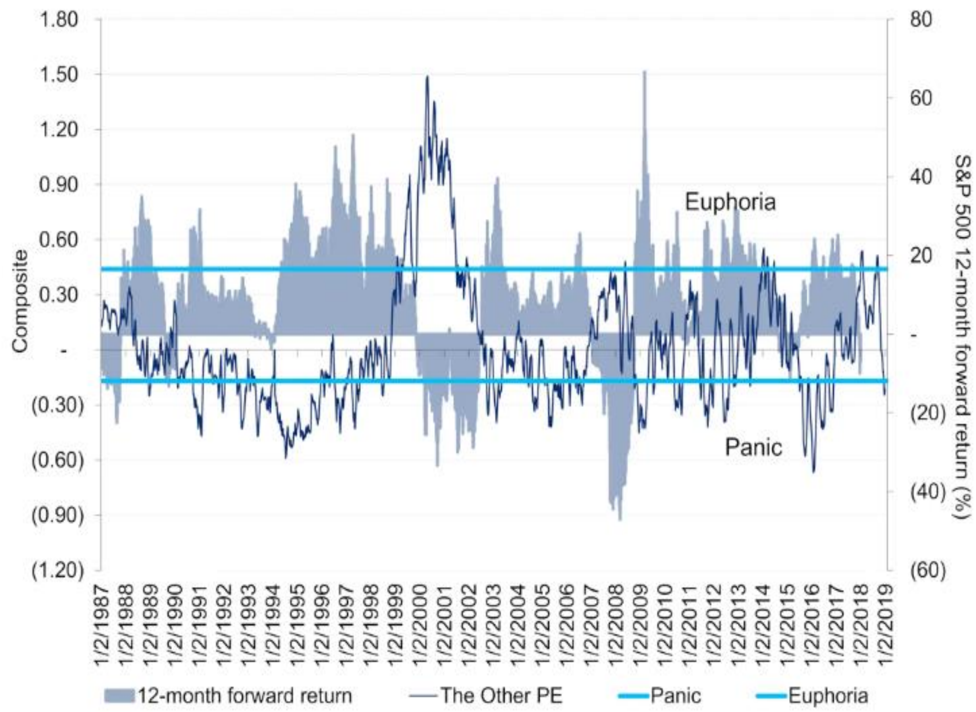
Fundamentals and technicals…

Please don't make me say it!

M&A and IPOs as % of Market Cap[1]



Panic / Euphoria Model[2]



Source: Citibank Research, Dealogic, MSCI as at 29 November 2018. 2 Pinnacle data, Haver Analytics, Citi Research as at 31 December 2018.

Tail risks abound

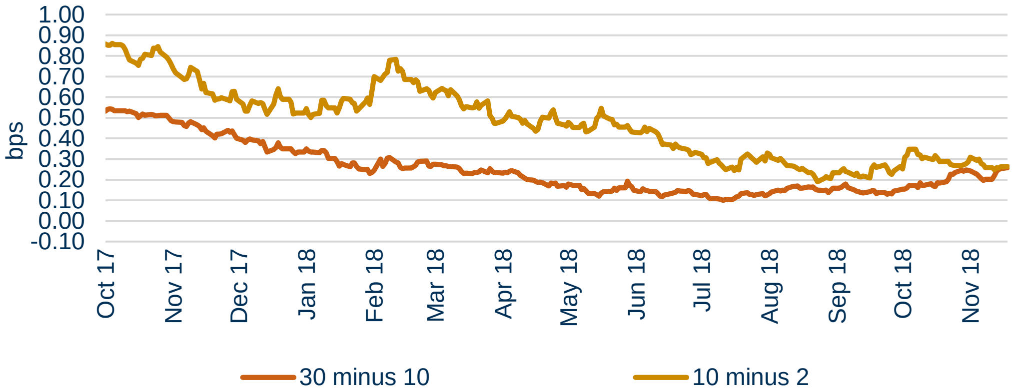
But hedges are ***CHEAP***!

Three huge risks on the horizon

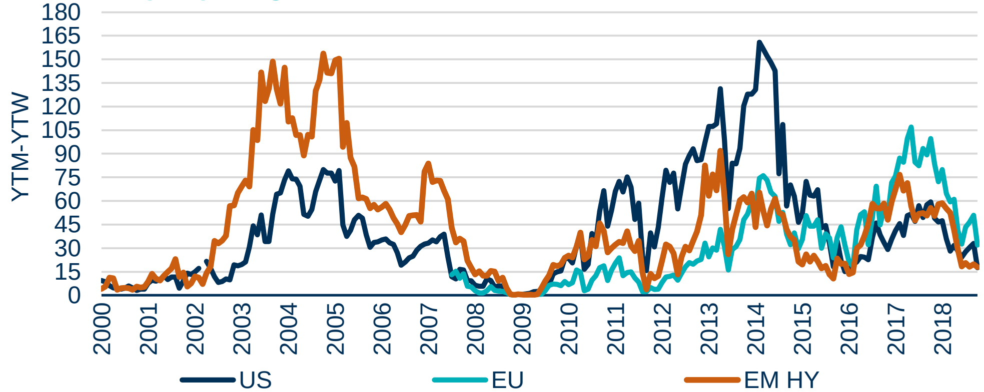
1. Unwind of largest financial experiment in history
2. Populism / protectionism / rule of law
3. Climate change

Credit market views

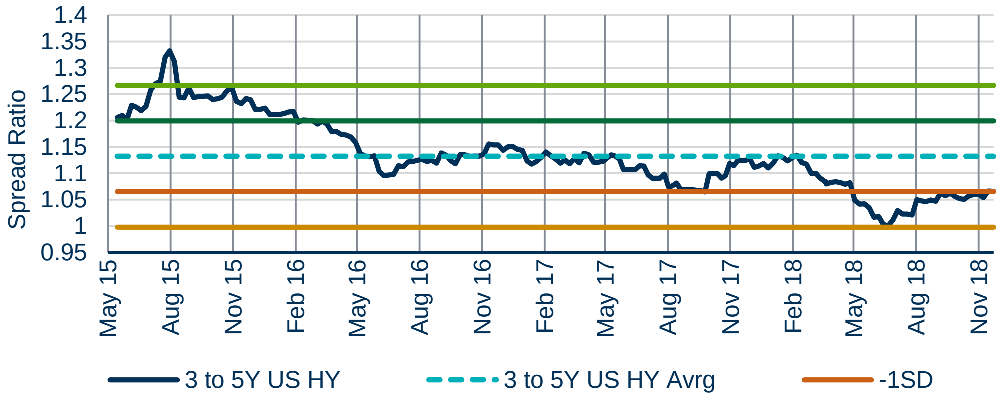
2v10, 10v30[1]



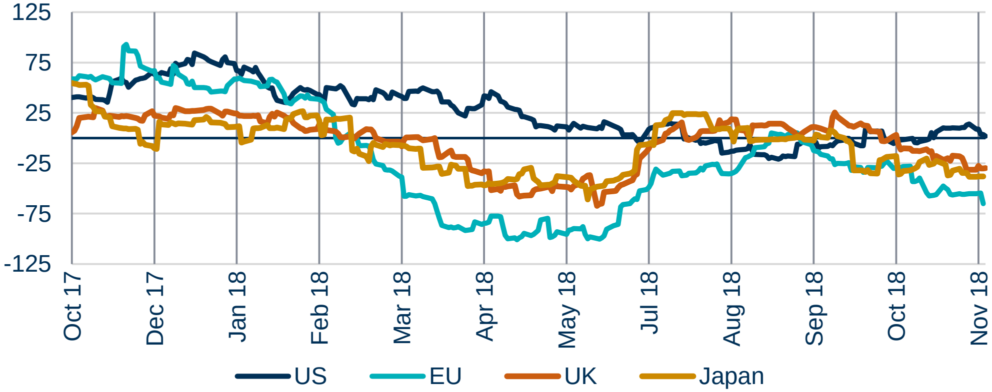
Convexity by region YTM - YTW[2]



3 to 5 years[3]



Economic surprise indices[4]



Source: [1] Hermes and Bloomberg as at 19 November 2018. [2] BofA Merrill Lynch Global Research as at 31 October 2018.
[3] Hermes and Bloomberg as at 23 November 2018. [4] Source: Reuters Datastream (based on national sources) as at 30 June 2018.

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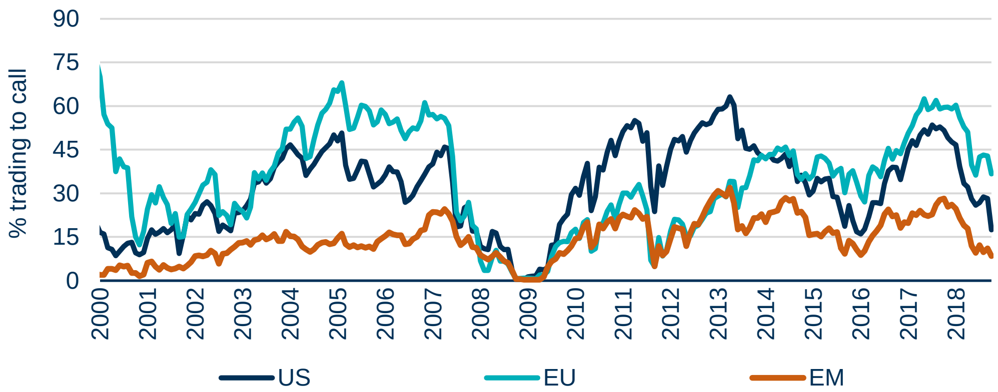
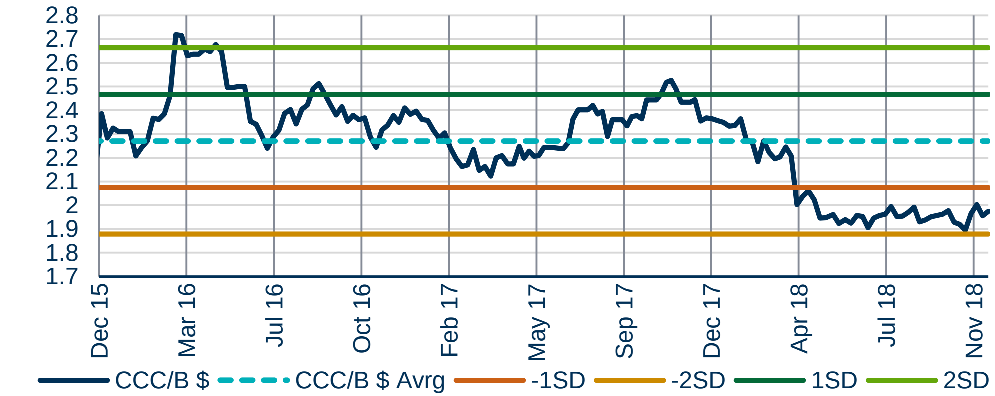
Intra-credit relative value

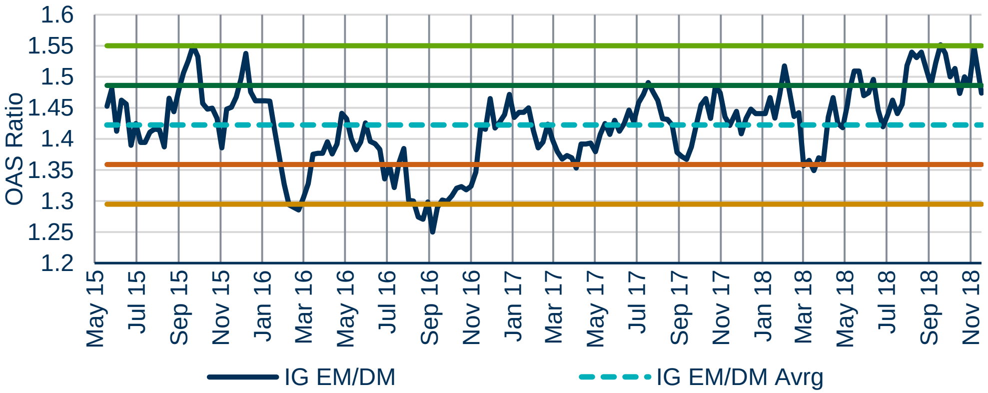
Convexity by region (% trading above call)[1]



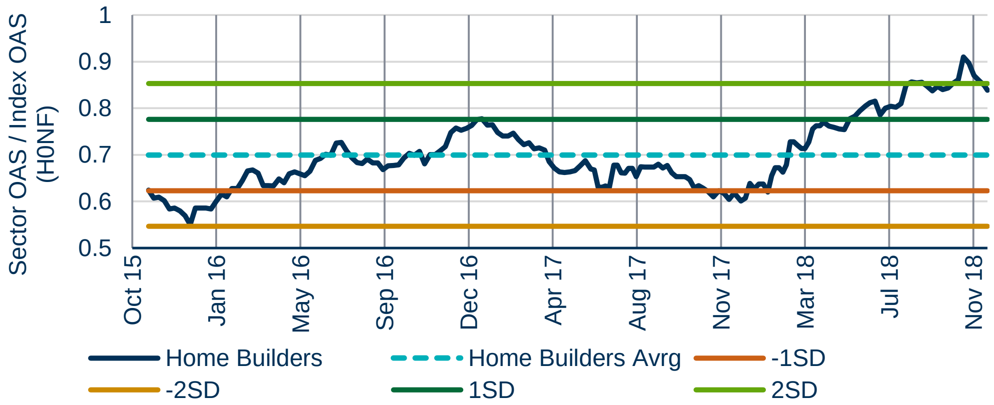
CCC/B USD[2]



Investment Grade – EM v DM



Homebuilders[4]

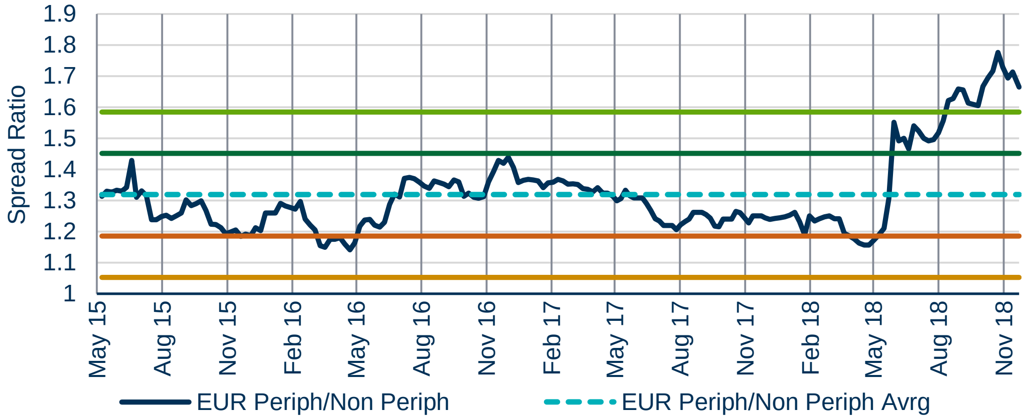


Source: [1] BofA Merrill Lynch Global Research as at 31 October 2018. [2] Hermes and Bloomberg as at 23 November 2018.
[3] Hermes and Bloomberg as at 23 November 2018. [4] Source: Reuters Datastream (based on national sources) as at 23 November 2018.

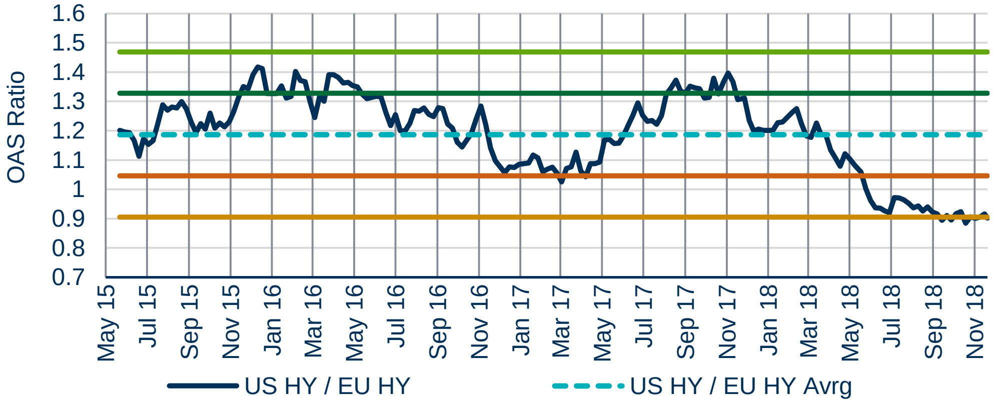
HERMES INVESTMENT MANAGEMENT

Intra-credit relative value

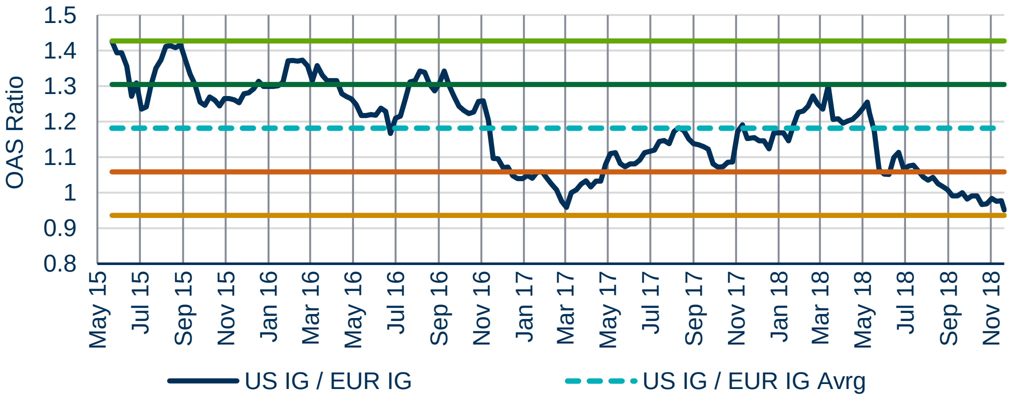
Peripheral Financials[1]



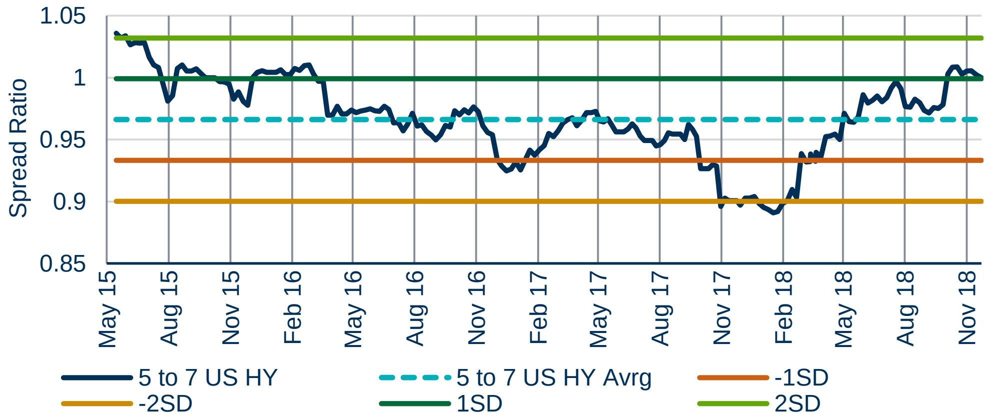
High Yield – US v EU[2]



Investment Grade – EU v US[3]



5 to 7 years[4]



Source: [1] Hermes and Bloomberg as at 23 November 2018. [2] Hermes and Bloomberg as at 23 November 2018. [3] Hermes and Bloomberg as at 23 November 2018. [4] Hermes and Bloomberg as at 23 November 2018.

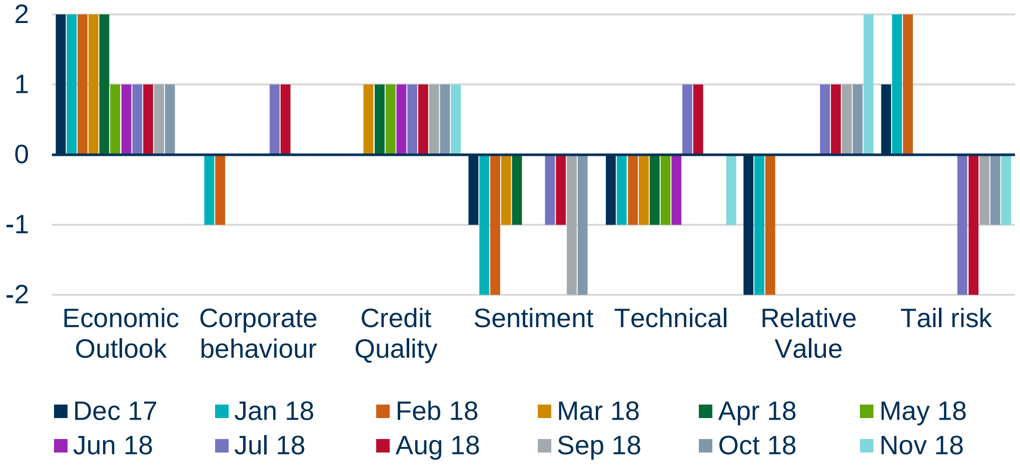
HERMES INVESTMENT MANAGEMENT

Applying top-down analysis

Identifying sources of risk and opportunity in credit markets

Monthly credit strategy meeting

- ► Reviewing global markets
- ► Gauge the influence of technical forces on valuations
- ► Headline credit score expresses our overall risk appetite

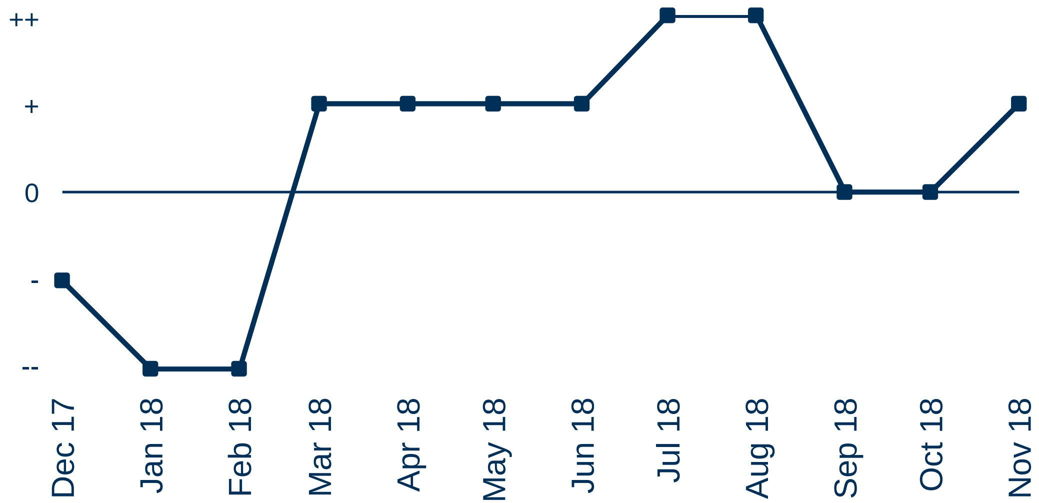


Source: Hermes as at 26 November 2018.

Risk appetite throughout 2017/18

- ► Establish appetite for credit risk and how to allocate that risk across geographies, sectors, rating categories, credit curves, etc

Credit risk appetite throughout 2017/18

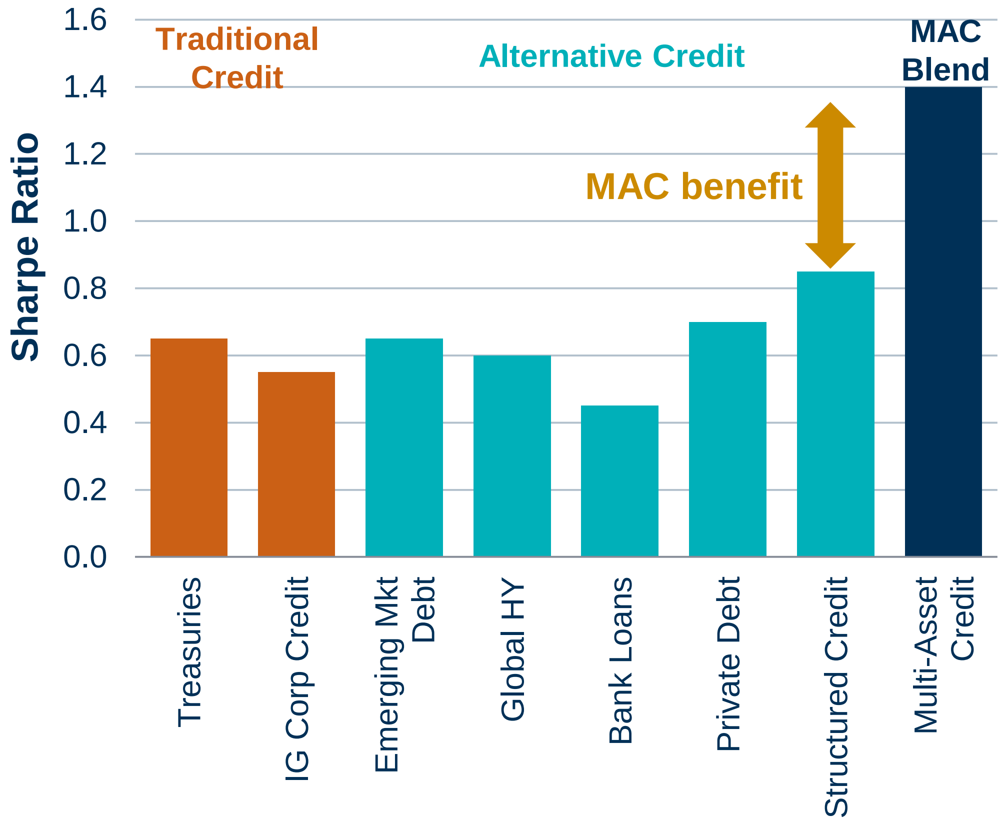


Changes to the credit landscape

Restrictions on traditional lenders have created investment opportunities

Opportunities from landscape developments

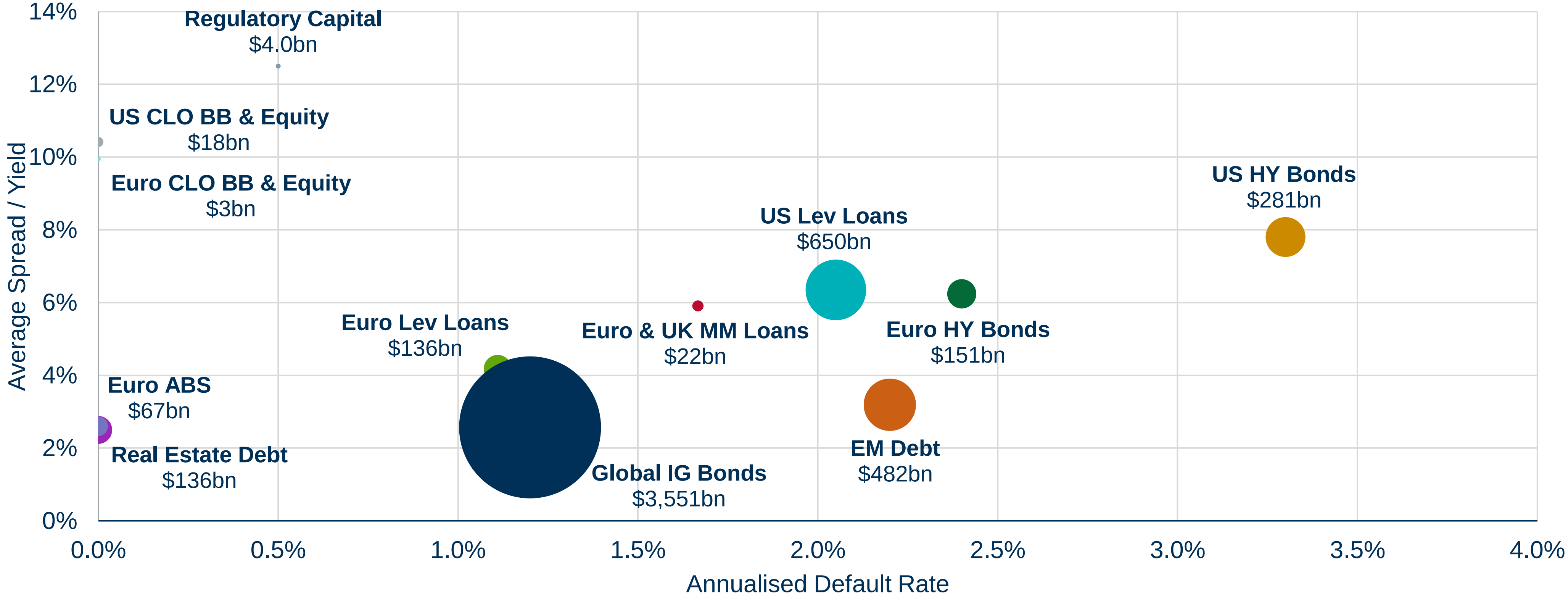
- Access to attractive areas where regulations restrict traditional lenders
- Yield premium in risk transfer with banks
- First mover opportunities in new asset classes
- Investment/partnership opportunities following rise in alternative lenders
- Attractive first loss exposures following “skin in the game” for structured credit issuers



MAC strategies provide one way for investors to access these opportunities

MAC provides broader credit access

A spectrum of opportunities available across public & private credit



The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results and targets are not guaranteed.

Source: Bloomberg, Thomson Reuters, S&P LCD, JP Morgan, Deloitte, Hermes (2017).

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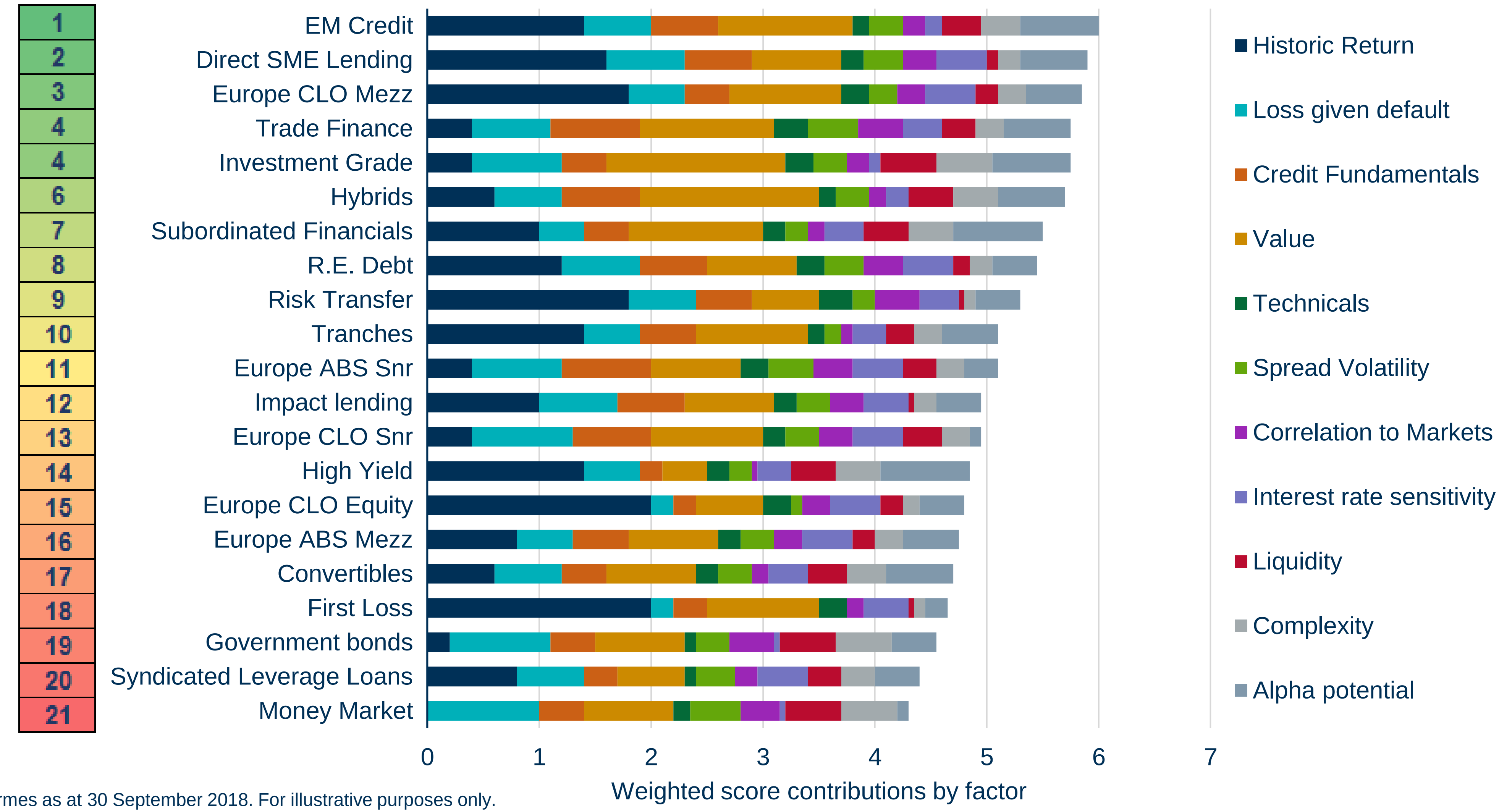
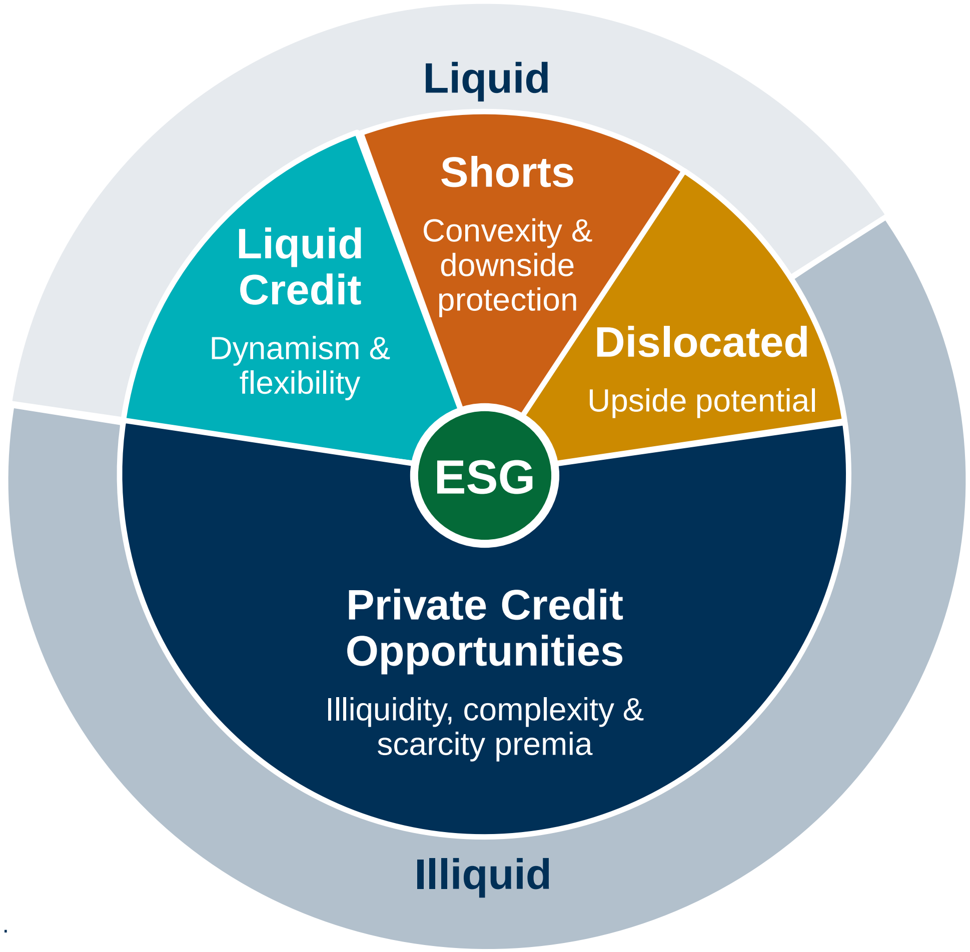
Relative value ranking and factor contributions



Source: Hermes as at 30 September 2018. For illustrative purposes only.

Multi Asset Credit Strategy

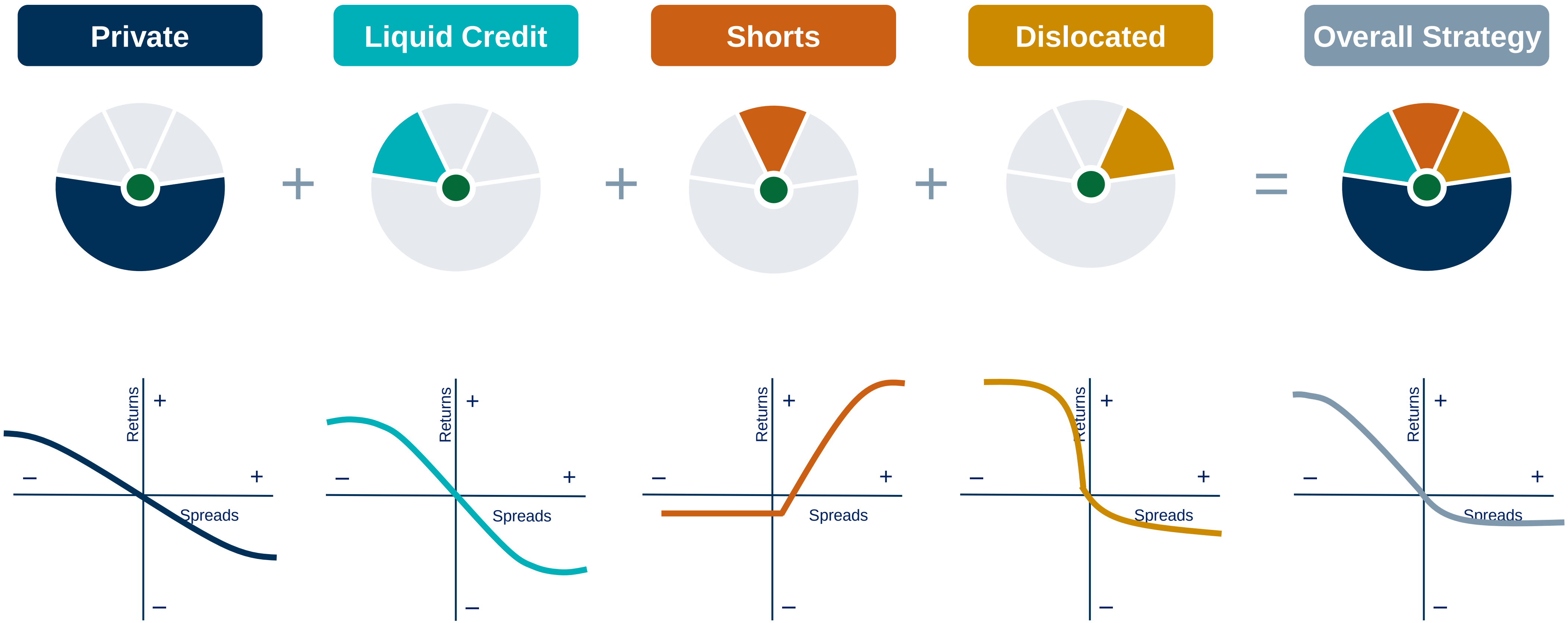
Diversified and flexible solution made up of two core portfolios:



1. **Liquid: Fully funded, dynamic allocation**
   - ► **Liquid Credit: long-only best liquid MAC ideas**
     - Targets libor +6% annualised over the market cycle
     - Provides agility to exploit market opportunities
   - ► **Shorts:** Dynamic options hedge overlay
     - Estimated 1.5% annualised portfolio cost
     - Downside protection by hedging market risk of portfolio
2. **Illiquid: allocation from drawn capital**
   - ► **Private Credit opportunities:** diversified allocation to private esoteric credit opportunities
     - Target returns of 8-12%
   - ► **Dislocated:** opportunistically sourcing distressed or dislocated assets during a market sell off (both liquid & illiquid assets)
     - Potential to provide returns of 15-20%
     - Funded from liquid and short allocations

Outcome oriented by design

Tailor return profile by combining different pay-off profiles



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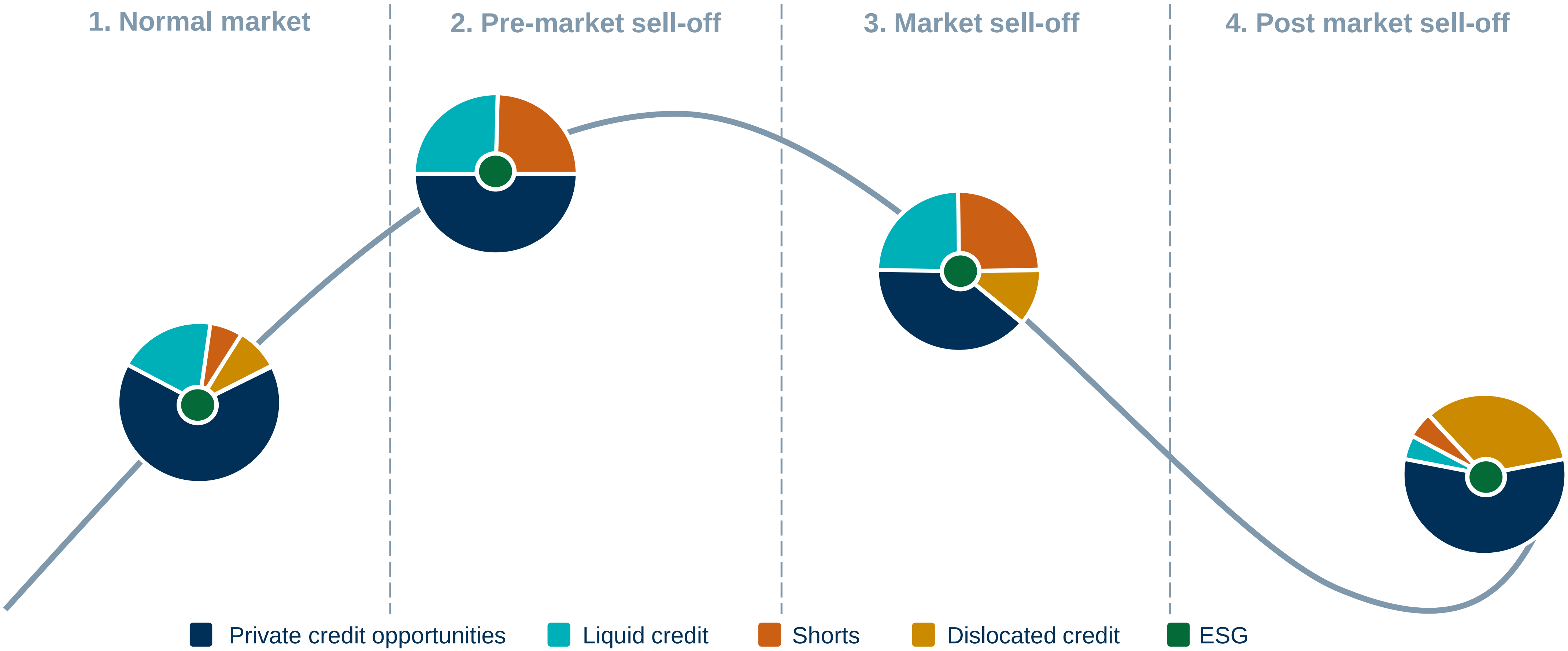
Flexibility to exploit opportunities and hedge risk

Illustration of how the composition may change over a market cycle



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OUTCOMES BEYOND PERFORMANCE

Hermes Investment Management

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

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For more information, visit **www.hermes-investment.com** or connect with us on social media:

Investing With Rising Risk Premia

Al Breach
Gemsstock, Co-Founder

GEMSSTOCK

Company

- Gemsstock Limited ("Gemsstock") is a London based, investment management company. Gemsstock is authorised and regulated by the Financial Conduct Authority.
- Setup in September 2013.
- Firm AUM (all in the macro strategy) $1.3bn.

Funds

- Currently manage one global macro strategy, the Gemsstock Fund which was setup in late 2010 by Al Breach who managed it alone until May 2014 when Gemsstock Ltd took over management.
- Al Breach and Darren Read are co-PMs on the Gemsstock Fund which is a multi-asset, absolute return, value-orientated fund.
- Launching a 2nd fund in early 2019 in L/S credit space.

Team

- Gemsstock has 14 employees, 9 of which are shareholders in the company.
- In addition to the two co-PMs, 12 further experienced market professionals complete the team, with Gemsstock benefitting from a cumulative 100+ years of market experience across asset management, equity / economics research, sales and trading, marketing and operations.
- The team's market education started during the crisis-prone 1990s in emerging markets, an excellent environment to learn macro economics in practice.

Culture

- Core members of team have substantial portions of their net worth invested in the fund.
- Performance, conviction and capital preservation are at the heart of the Gemsstock culture.
- A fee structure that fully aligns our interests with those of our investors.

Al Breach

- Al Breach has managed the Gemsstock Fund since late 2010.
- During 2003-2007 he was the Head of Research, Economist and Strategist for Brunswick UBS in Moscow.
- From 1998-2003 he was the Russia Economist for Goldman Sachs.
- Al also co–founded The Browser.com and is a board-member of Bank of Georgia.

Why what just happened (1)
QE goes into reverse, mechanically pushing up risk-premia

GEMSSTOCK

- Two decades of big central bank money creation have come to an end
- After so long and so much of this stimulus, risk premia will surely go up

Chart 1: Aggregate QE and FX reserve growth, $ bn

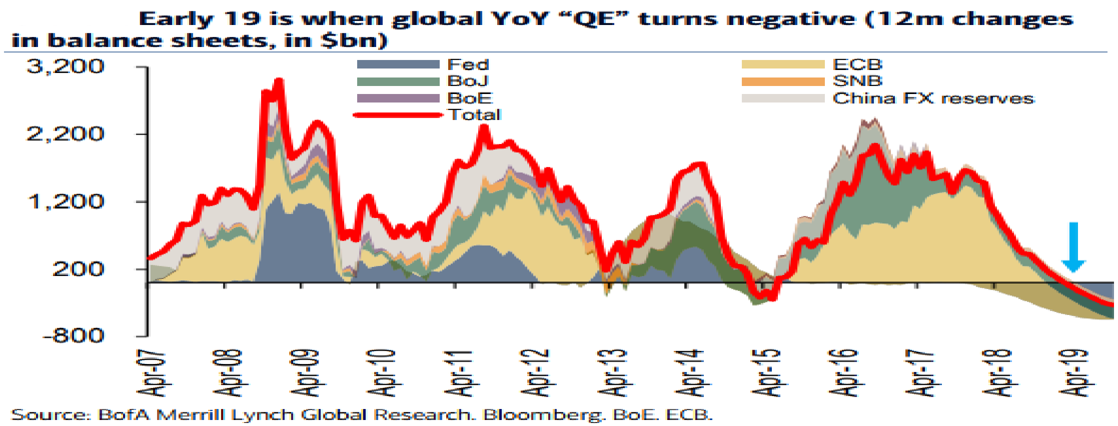
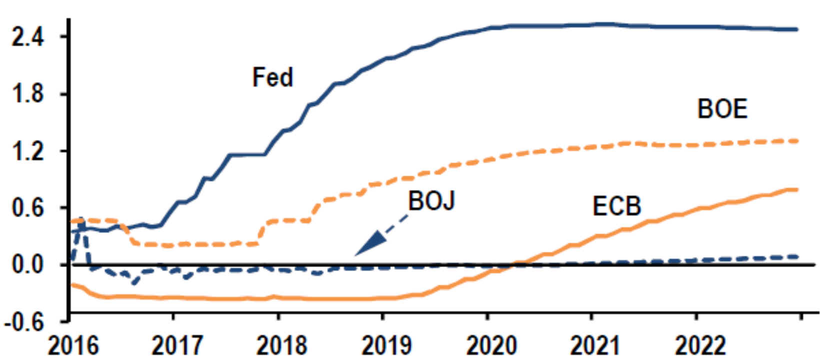


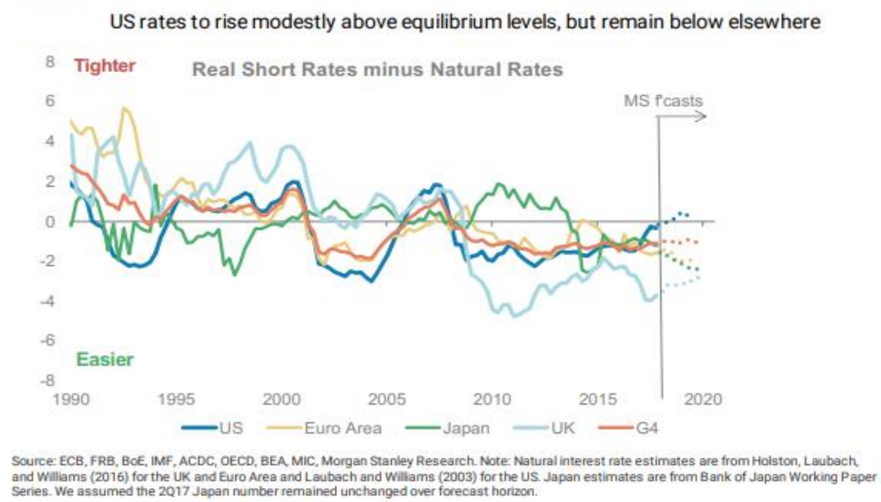
Chart 2: Normalising rates: Expected CB policy rates

1 month OIS, %p.a.



Source: IMF Global Financial Stability Report

Chart 3: Normalising rates: Headed to neutral and higher?



Anti-globalisation and Trump's tariff wildness push up uncertainty & threaten margins

- Tariffs, sanctions and increasing number of countries with populist politics is a profound change and challenge

Chart 4: Three decades of globalisation

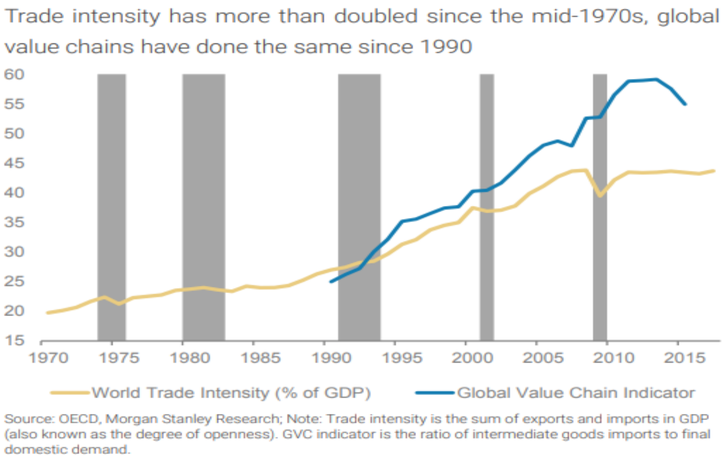


Chart 5: US Trade balance by stage of processing, $ bn

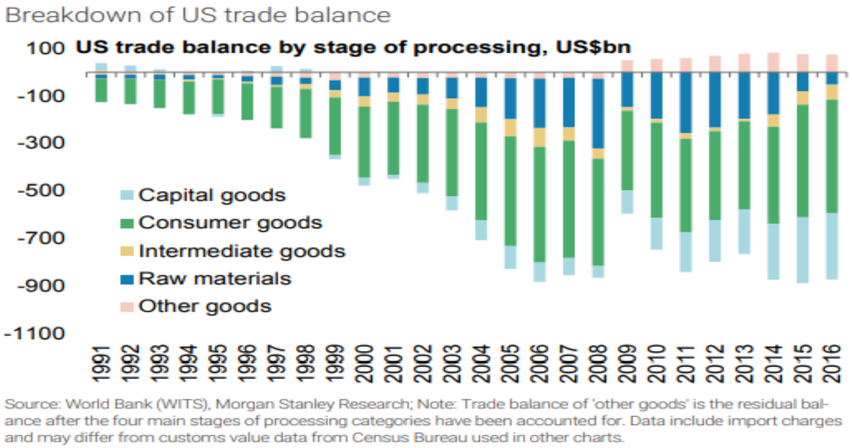


Chart 6: Ever lower tariffs, until now

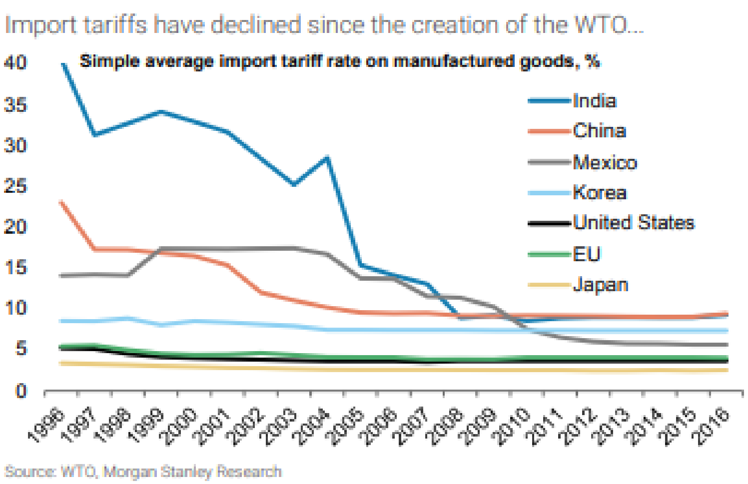
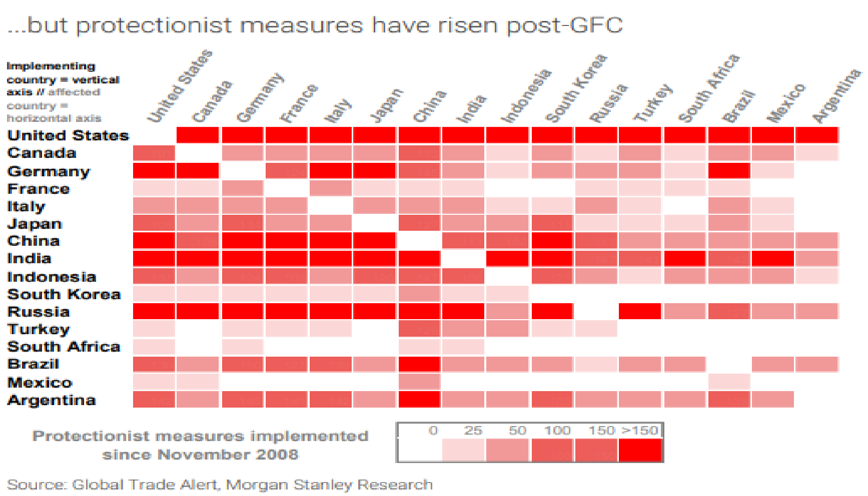


Chart 7: Protectionist measures increasing



Big Question for 2019/2020: Recession or mid-cycle slowdown?

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Or, will the next Fed rate move be down or up?

Numbers of factors make the question real and uncertain – lights amber, not yet red:

(i) A wise market? Or a market / risk-premium event?

(ii) A self-reinforcing slowdown? But imbalances not obvious

(iii) US-China & other trade negotiations: Deals needed

(iv) Oil prices: self-off a positive as long as does not extend. $50 the norm now?

(v) US fiscal is worrisome; due to become a drag late 2019 / early 2020.

(vi) China really is slowing

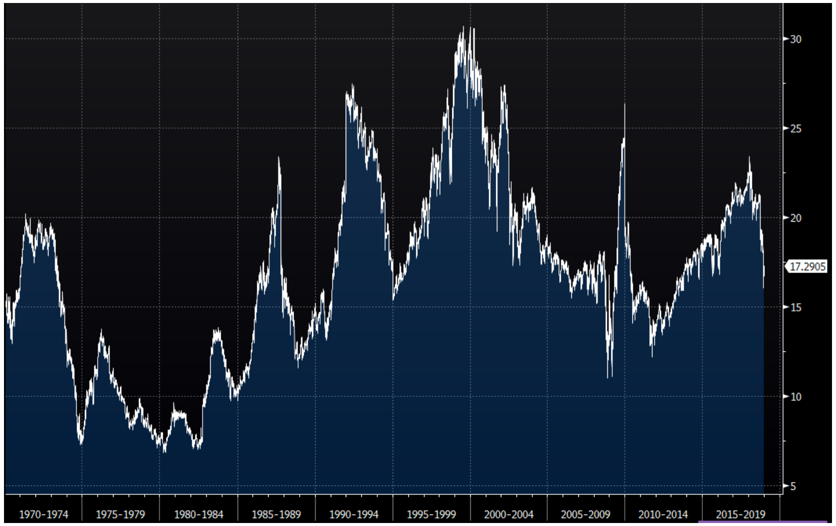
(i) A wise market? Or a market / risk-premium event?

- Cyclicals hammered: is the market spotting a coming recession?
- Can the wealth effect drive a recession? 30% of GDP peak-to-trough falls have previously prefigured or were coincident with recessions
- Or is the market, learning from last cycles, front-running a worry?
- 1998?

Chart 8: US Total Market Cap / GDP

Source: Gurufocus.com

Chart 9: US P/E (trailing 12 months)



Source: Bloomberg

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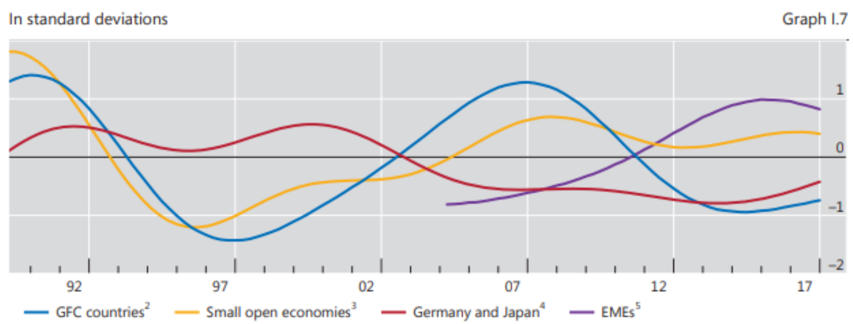
- 50+% of CFOs expect US to be in a recession by late 2019; 80+% by end 2020
- But no imbalances and labour income solid
- Manufacturing but not services?

Chart 10: Financial cycles largely supportive (BIS)



[1] Financial cycles are measured by frequency-based (bandpass) filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices. Financial cycles are normalised by country-specific means and standard deviations before simple averages are taken for country groupings. [2] ES, FR, GB, IT and US. [3] AU, CA, CH, FI, NO and SE. [4] Germany and Japan are aggregated together as their respective cycles have been asynchronous with other AEs. [5] BR, CL, CO, HK, ID, KR, MX, MY, PE, SG and TH.

Sources: National data; BIS; BIS calculations.

Chart 11: US Private Sector Savings

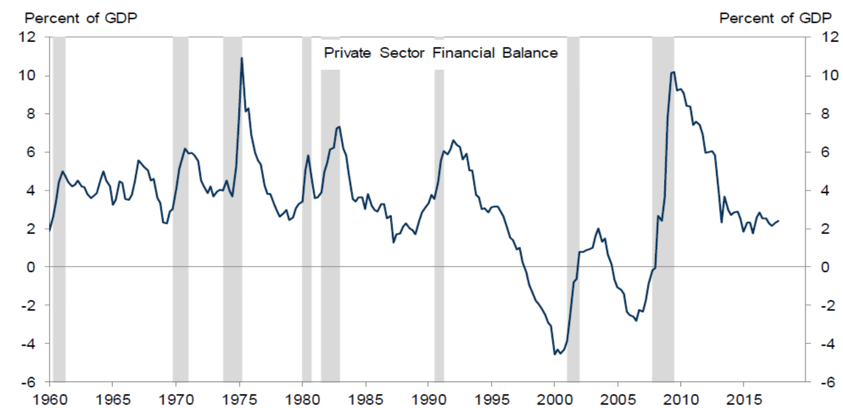
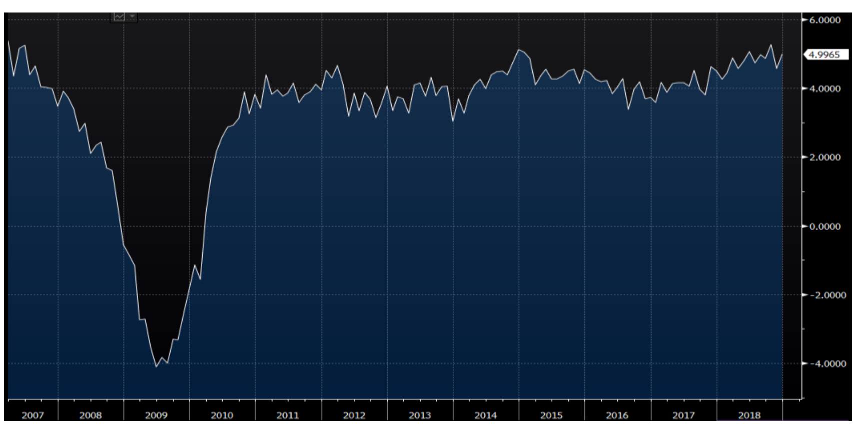


Chart 12: US Total Labour Income*



Source: Bloomberg

*Defined as YoY % change in (Total NFP Employees * Average Hourly Earnings in USD * Average Weekly Hours Worked)

Chart 13: US wage growth, %

Source: BLS, Haver Analytics, Morgan Stanley Research; *Inflationary pressures from a tightening labour market are limited so far as wage growth remains moderate and below productivity growth (non-farm business sector output per hour in this graph) plus the 2%Y inflation target

(iii) US-China (& other) Trade Negotiations: Deals needed

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Enlightened Self-Interest?

OR

Tariff Man?

We wait again … end February for 90-day US-China delay, and for decision on auto-tariffs

(iv) Oil prices: Sell-off a positive as long as does not extend *$50 / bbl WTI the mid-term ceiling now?*

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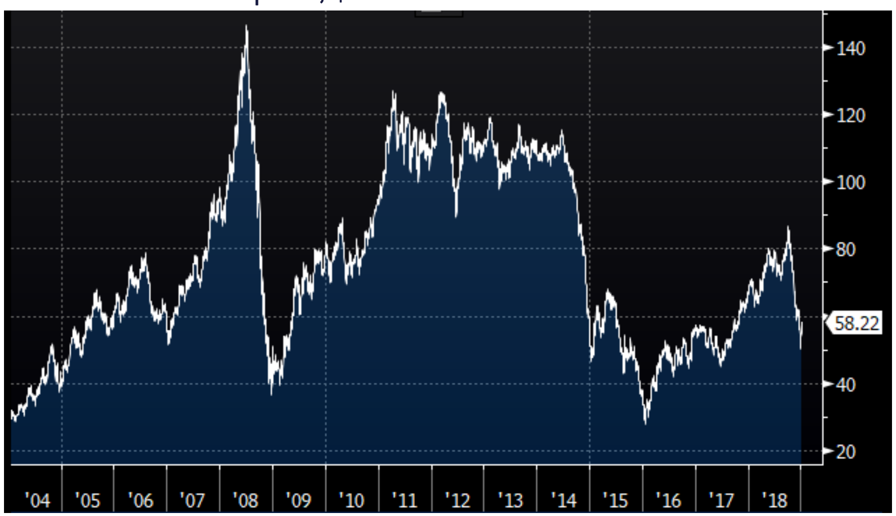
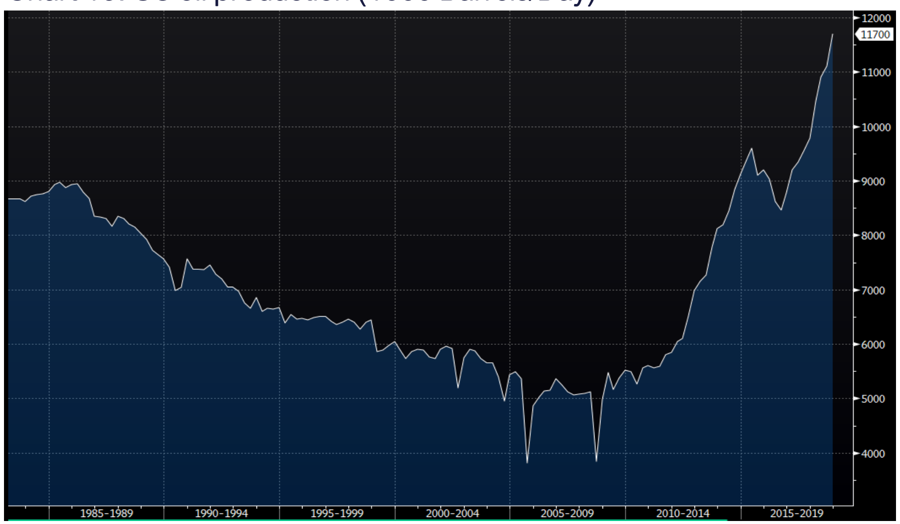
- Oil could not sustain the higher prices of 2017 / 2018 as US shale production re-accelerated
- Soft oil prices is a positive for global growth …
- Less so for US (for oil-related capex to be maintained need WTI above $45 or so mid-term) ..
- & not good for capital markets (oil rents typically saved; lower oil prices mean more spending)

Chart 14: Brent oil price, $



Source: Bloomberg

Chart 15: US oil production (1000 Barrels/Day)



Source: Bloomberg, US Department of Energy

(v) US fiscal is worrisome; due to be drag in late 2019 / early 2020

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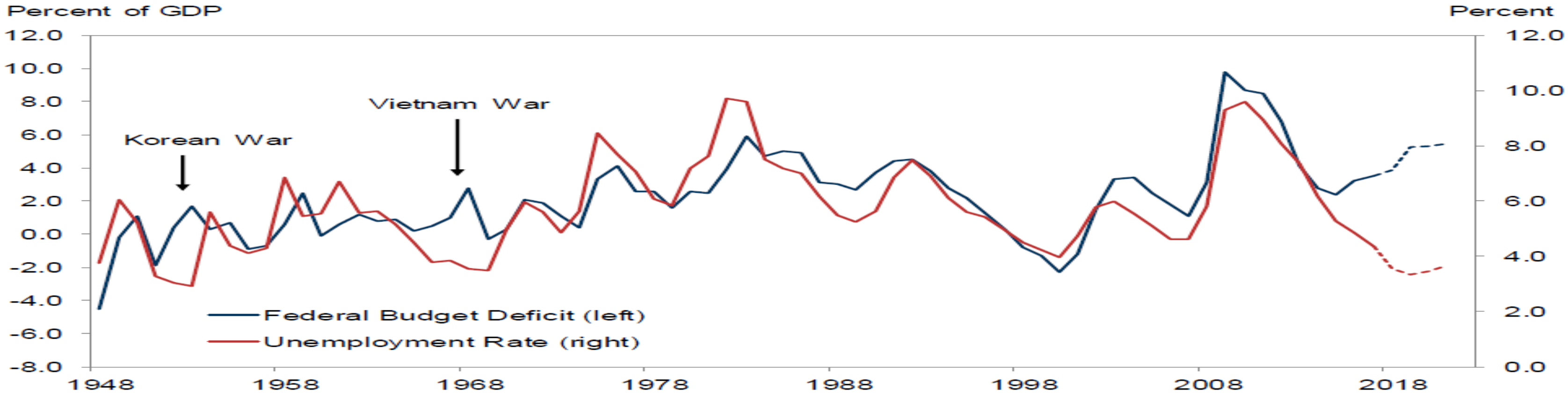
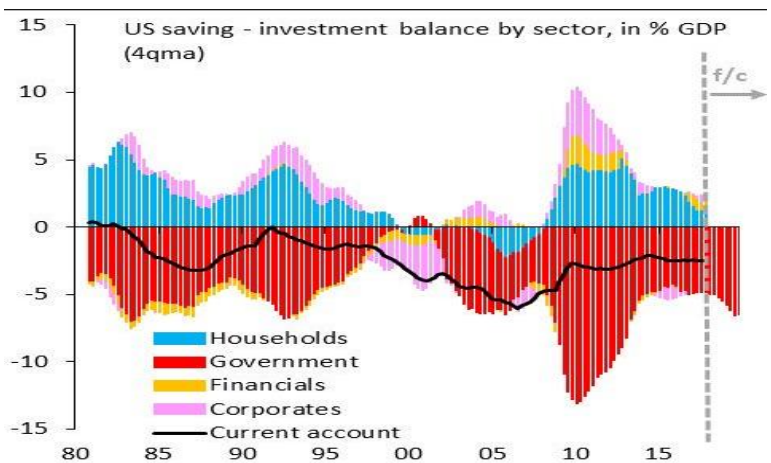
- The a-cyclical widening of the budget deficit + QT pushes up risk premia
- Longer-term implications of US deficits & dis-functional politics are scary, further adding to risk premia
- Current plans suggest fiscal becoming a drag in late 2019 / early 2020. Elections?

Chart 16: US Budget deficit & Unemployment rate: A scary chart



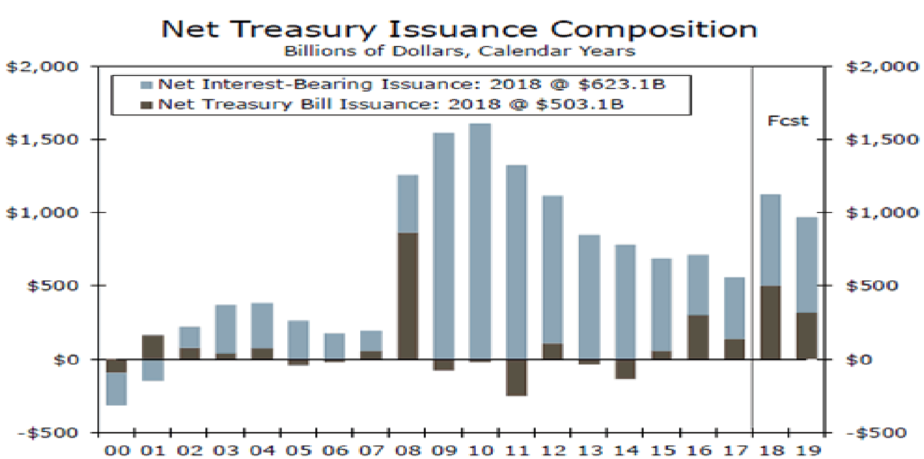
Source: Goldman Sachs Research

Chart 17: US: Expanding deficits



Source: IMF

Chart 18: US Net Treasury issuance



(vi) China really is slowing

- China's two decades of rampant growth are over
- Question is whether this is now like Japan's 1990s

Chart 19: China reported and actual GDP growth %

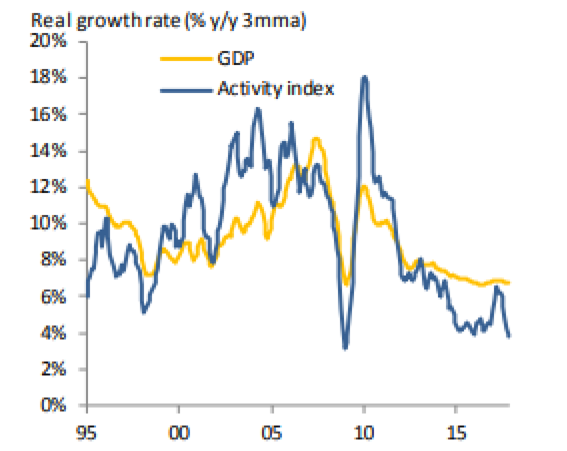


Chart 20: China: GDP % approaching Asian peers

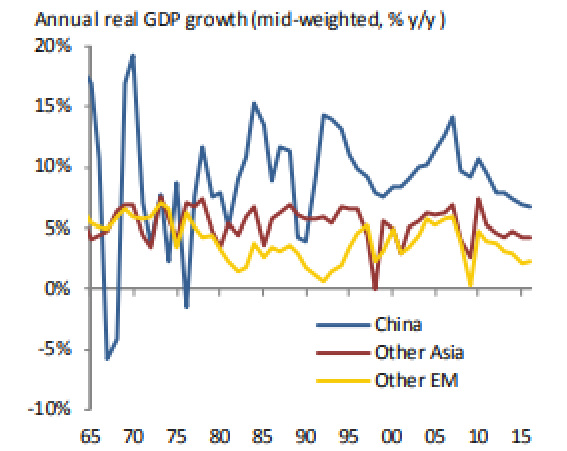


Chart 21: China: Fixed asset investment ebbs

Chart 22: China: Declining money growth

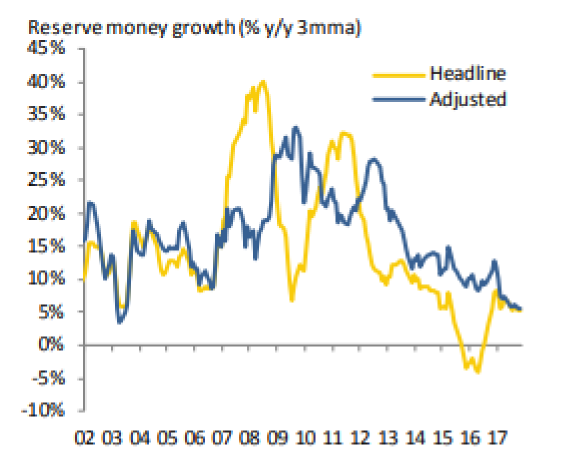


Chart 23: China: Investment no longer the driver

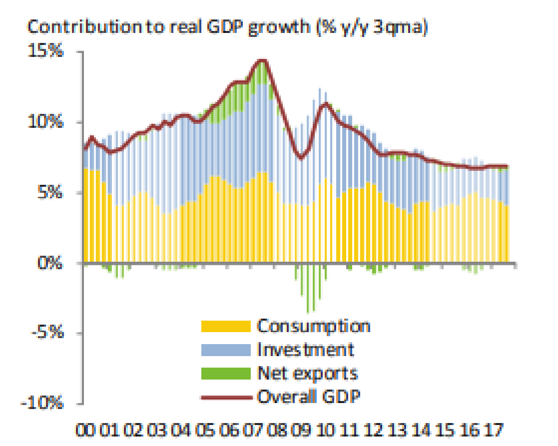
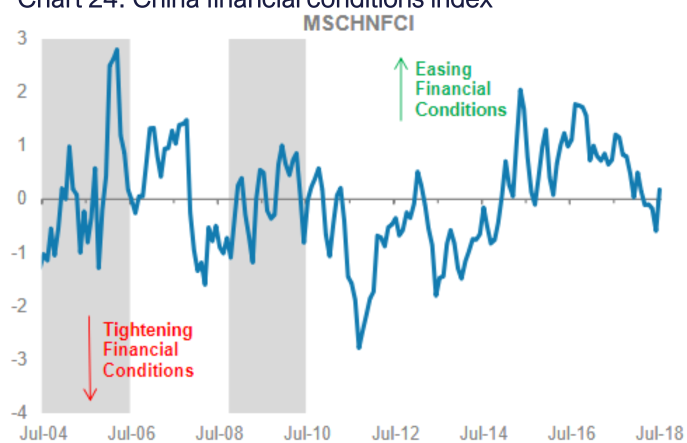


Chart 24: China financial conditions index



Source: WSJ, National Data Sources, Morgan Stanley Research

Source: Emerging Advisors Group

Conclusions & Market Implications

- Our base case is a mid-cycle slowdown, with the Fed's next rate move a hike. 1998, sort of
- But there is a good chance of a manufacturing recession (are we in one already?)
- We cannot be confident of this view until, at least, end February, given the trade talks and their importance. Quite likely we'll need to wait longer. We are all data dependent
- The weakness of data in Q1 will keep the market on the back foot; risk premia won't come down for some time – they are more likely to keep edging up
- The Fed has stopped hiking for now; will it amend / curtail QT? We suspect it won't but very contingent on the above working out OK
- Until the next rate move of the Fed becomes clear, hard to see US$ getting stronger or much weaker; if the next move is down a US$ bear market will have begun
- Corporates to de-lever? We now get the inverse of the debt-financed buy-backs?
- Marginal borrowers to keep suffering

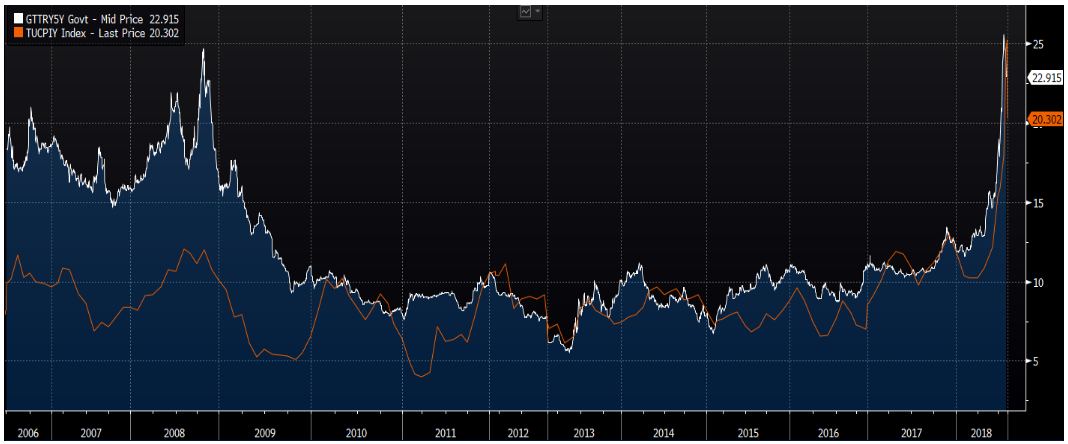
How we are investing

- Overall stance: Remaining cautious; looking for a late Q1 / Q2 opportunity to fade worries - or get outright bearish
- DM Rates: Little for now; waiting on the above
- EM Rates & FX: Selectively long, at least in Q1 window; in those that have adjusted / are adjusting
- Credit: Gingerly looking to add. This year's likely best long opportunities. In those that have fallen / moved to de-levering plus AT1s. But patient in Q1; still net short
- Equities: Shorts for any longs; balance sheet trades with debt & equity
- FX: Little for now, except in EM

- Coherent policy can deliver good cyclical returns; can Erdogan allow adjustment to continue?
- We are long local currency bonds

Charts 25: Turkey: Yields, inflation & REER

Turkish CPI (orange line) vs 5Y Govt Bond Yield

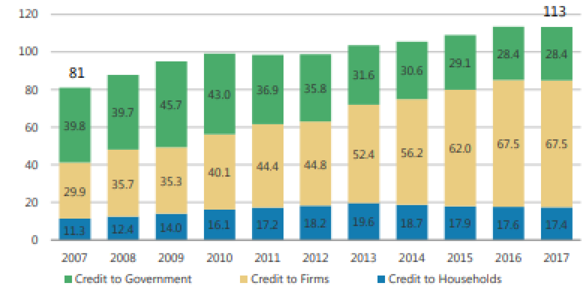


Turkey CPI-Based Real Broad Exchange Rate

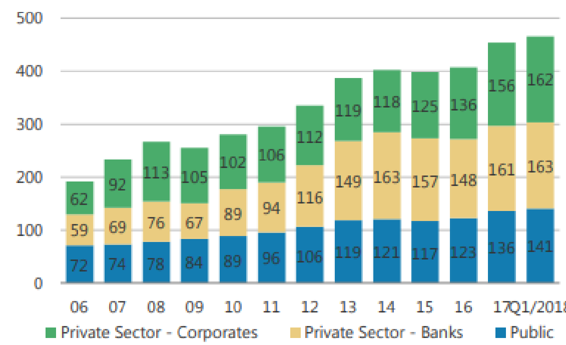
Source: Bloomberg

Charts 26: Turkey: Various debt measures

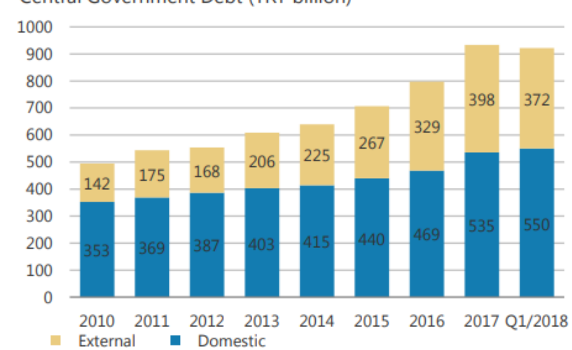
Credit to Non-Financial Sector to GDP (%)



External Debt Stock (USD Billion)



Central Government Debt (TRY billion)



Source: Morgan Stanley Research

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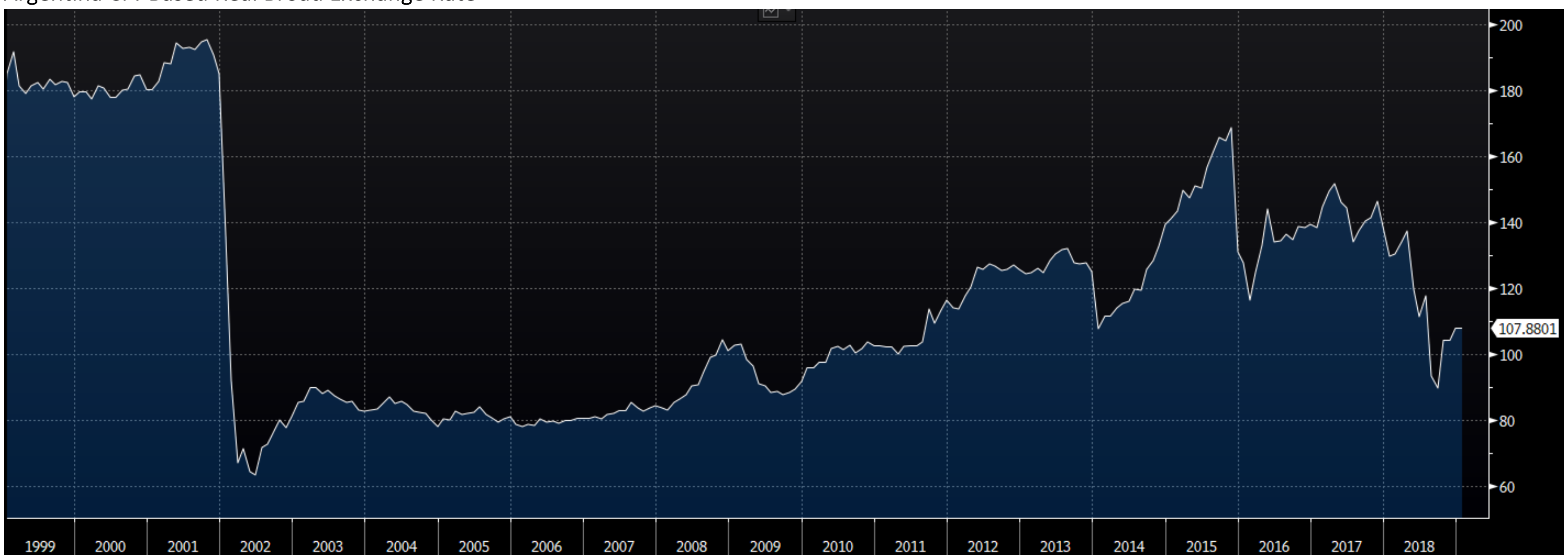
- Argentina's age old problem is a profligate government, big public debts and tiny domestic capital markets following serial abuse
- Macri's government is committed to trying to deal with the deficits but 2019 elections, a thumping recession and that history make it a decidedly tough political challenge
- The devaluation offers hope but high FX debt means public debt levels mean narrow path
- We are long local currency debt, but protected through buying CDS protection

Chart 27: Argentina REER

Argentina CPI-Based Real Broad Exchange Rate



Source: Bloomberg

Questions?

Q & A

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