

Groundhog Day: The Cost of Forecasting the End

February 2019 Commentary



“Forecasts create the mirage that the future is knowable.” — financial historian Peter L. Bernstein

Executive Summary

- We believe the current cycle could continue for a while longer, notwithstanding predictions to the contrary.
- Recent global central bank pivots have been supportive of credit performance.
- Market fundamentals and technical shifts have also been constructive.
- Our active management style focuses on what is observable, what is knowable and understanding value.
- The lessons of 2018 have left us much better positioned to preserve capital, or extract value, as we move forward.

THE CURRENT CYCLE COULD EXTEND FOR SOME TIME – THERE ARE COSTS TO BEING UNDERINVESTED

On Groundhog Day 2019, the famous Punxsutawney groundhog Phil could not find his shadow, predicting Pennsylvania is in for an early spring. Going back to 1887, Phil’s calls have been correct about 39% of the time – worse than random odds. Wall Street forecasts have generally been no better. One potential cost of forecast errors is that investors forego reasonable returns as worry for the future leaves them underinvested today. Particularly in fixed income markets where active management can capture inefficiencies, and skew risk/reward so heavily in favor of investors, we see this bias as sub-optimal.

The term Groundhog Day has also become synonymous with recurring events. In the 1993 movie of the same name, character Phil Connors (Bill Murray) finds himself caught in a time loop, repeatedly reliving the same day. In the movie, Phil quips, *What if there is no tomorrow? There wasn't one today.* Although there is certainly value in being positioned and prepared for the worse, we can never know when that will come - particularly as global central banks begin to once again turn dovish, enacting their own Groundhog Day playbook. Investors could, in fact, find themselves holding dry powder for a day that is continually kicked down the road.

Whether it be calls for the end of the cycle, the demise of BBB rated credit, possible Brexit outcomes – we’d argue that trying to predict the end state is misguided. Allowing later cycle fears to override observable market evidence could translate into a prolonged period of lost opportunity. In our view, an active approach, that takes proper account of risk and reward, will optimize investor outcomes through the cycle.

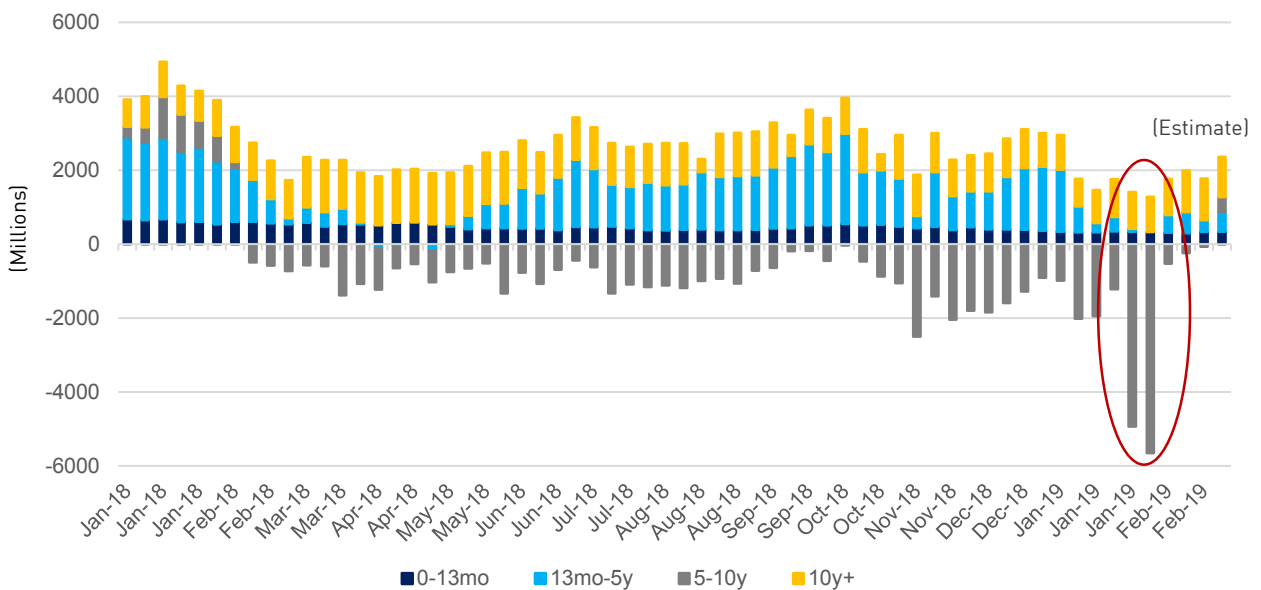
Our focus is what is observable, what is knowable, and what valuation makes sense. Our current observations offer evidence that credit markets could continue to perform. Building on January’s momentum, we are pleased to report that we were able to produce strong returns, once again, in February.

CREDIT BACKDROP REMAINS SUPPORTIVE

Fundamentals remained supportive of credit in February. The combination of a dovish Fed, improving U.S./China trade negotiations and stronger data all provided a decent backdrop for credit performance. Although U.S. GDP growth has softened in recent quarters, it remains healthy having grown in Q4/18 at a respectable 2.6% annualized pace while other U.S. indicators have demonstrated good traction – including leading indicators such as the Chicago Purchasing Managers index which rose to 64.7 in February, up from January’s 56.7 reading. As well, U.S. consumer confidence rebounded sharply in February printing at 131.4 (vs. Jan 121.7). Meanwhile more recent global inflation prints have generally been steady or trending lower and the ECB has generally been turning more dovish, bringing down both its inflation and growth forecasts. Taken together, the U.S. economic backdrop remains a good one while developments in Europe remain supportive of easy monetary policy conditions.

Technicals also remain very constructive. From a technical perspective, there were some very positive developments in February, potentially leading to a nice performance set up for March. The flow of funds into U.S. high grade mutual funds and ETFs throughout the month was quite strong. In fact, the first week of February saw the fourth largest inflow on record. New issue supply in the U.S. was up from February 2018 levels but performed well – with new issues performing at levels not seen since early 2017. In Canada, supply was quite light, down ~25% from the previous year, which bolstered Canadian credit performance. We continue to see foreign buying coming into the U.S. market, as measured by TRACE data. This data tracks the sale of bonds by U.S. banks to foreign affiliates – an important indicator of foreign demand for U.S. bonds. As well, dealer inventories remained very light with High Yield inventories at some of the most negative levels seen (Figure 1). The importance of this is that counterparty buyers would likely represent fund and ETF buyers – suggesting that fixed income demand was very strong in the month.

Figure 1: U.S. high yield dealer inventories turned negative (-5.6 billion) in February - pointing to exceptionally strong demand in the month.



Source: Federal Reserve Bank of New York

DEFENSIVELY POSITIONED BUT EXTRACTING GOOD VALUE OPPORTUNISTICALLY

Constructive on credit but mindful of lingering risks. Globally, the accommodative backdrop being provided by the Fed, the Bank of Canada and most recently the ECB, remains constructive for credit. Having said that, risks remain. Trump politics, which could have either positive or negative consequences can't truly be modelled for. Inflation remains another important risk – although recent readings suggest that, if anything, global inflation may be receding. Still, an uptick in inflation could shift central bank and/or market sentiment quickly so we remain cautious. The Q4/18 reporting season exceeded expectations but largely on the back of lowered forecasts. We are watching to see if earnings expectations continue to revise lower. Finally, end of cycle worries could shift sentiment quickly. Against this, we must be exceedingly vigilant and mindful of how opportunities could play out on both the long and the short side of the market.

Seeking to extract value but with a keener focus on being able to pivot. In the context of generally constructive fundamental and technical developments, and the concerns highlighted above, we felt that our long positions needed to remain very liquid and we cleared out any positions that might become difficult to trade in a more difficult tape. As we traded in and out of value opportunities, we generally looked to keep overall risk across the portfolios steady – capturing value but not adding any incremental risk. As well, we remained on the hunt for good short selling candidates particularly in the retail, auto and subprime lending spaces. With a good deal of demand flowing into short dated paper, we evaluated the prospects of extending term modestly for short term trade should stability persist. This is all to say that we continue to seek out and extract value relentlessly wherever we can uncover it, but with a sharper focus on being able to pivot quickly should sentiment turn.

The extended nature of the current credit cycle lends itself to uneasiness but central bank pivots have now steadied expectations for rising rates, providing a more stable backdrop for risk markets. In addition, strong market technicals and improving U.S. data provide some evidence that opportunities to extract value will persist. The challenge for investors is that tomorrow could continue to look like today for an indeterminate period. We continue to believe that active, value oriented management can make a difference in investor outcomes - capitalizing on the opportunities that exist while prioritizing capital preservation.

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