ROCKEFELLER
ASSET MANAGEMENT

# MONTHLY Market Review

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## Party Like It's 1999

### From century bond to cov-lite loans; Risk being dissed as the dance goes on


**JIMMY CHANG, CFA**
*Chief Investment Strategist*
212-549-5218
jchang@rockco.com


The world is enjoying one of the best stretches of prosperity in quite a while. U.S. real GDP achieved 2.6% annualized growth in the second quarter, and China again expanded its economy 6.9% year-over-year. Germany's Ifo Pan-Germany Business Climate Index climbed to an all-time high in July. Japan's industrial production has grown for eight consecutive months. The solid economic backdrop fueled corporate earnings growth and pushed equities to all-time-highs. Indeed, July was another month of steady price appreciation. The VIX Index, a measure of expected stock market volatility, recently hit new lows going back to its inception in 1990. Charles Schwab reported the strongest first half of account openings in 17 years. The optimism lifted base metal prices, while crude oil prices spiked on a variety of factors including better gasoline demand and planned capital spending reduction by some U.S. producers. U.S. Treasury yields, however, declined slightly in spite of the Fed making it clear that it would kick off "quantitative tightening" later in the year. Investors continued to bet that the pace of tightening would be quite measured due to a muted inflation outlook. The one big loser was the U.S. dollar, which is off 9% year-to-date. The greenback's weakness helped precious metals and the renminbi move higher. The euro reached 30 month highs vs. the U.S. dollar, as the Eurozone's solid economic performance may push the European Central Bank to further taper its asset purchase in the not-too-distant future. Ironically, European politics appeared stable relative to Washington's dysfunction, which may get even worse in the coming months over the fiscal 2018 budget and the debt ceiling negotiation.

| Equity Markets Indices[1] | 6/30/2017 Price | 7/31/2017 Price | MTD Change | YTD Change |
|---|---|---|---|---|
| MSCI All Country World | 465 | 478 | 2.7% | 13.2% |
| S&P 500 | 2423 | 2470 | 1.9% | 10.3% |
| MSCI EAFE | 1883 | 1937 | 2.9% | 15.0% |
| Russell 2000®[2] | 1415 | 1425 | 0.7% | 5.0% |
| NASDAQ | 6140 | 6348 | 3.4% | 17.9% |
| TOPIX | 1612 | 1619 | 0.4% | 6.6% |
| KOSPI | 2392 | 2403 | 0.5% | 18.6% |
| Emerging Markets | 1011 | 1066 | 5.5% | 23.7% |
| **Fixed Income** | | | | |
| 2-Year US Treasury Note | 1.38% | 1.35% | -3 | 16 |
| 10-Year US Treasury Note | 2.31% | 2.30% | -1 | -15 |
| BarCap US Agg Corp Sprd | 1.09% | 1.02% | -7 | -21 |
| BarCap US Corp HY Sprd | 3.64% | 3.52% | -12 | -57 |
| **Currencies** | | | | |
| Australian (AUD/$) | 1.30 | 1.25 | 4.1% | 11.1% |
| Brazil Real (Real/$) | 3.31 | 3.13 | 5.8% | 4.2% |
| British Pound ($/GBP) | 1.30 | 1.32 | 1.5% | 7.1% |
| Euro ($/Euro) | 1.14 | 1.18 | 3.6% | 12.6% |
| Japanese Yen (Yen/$) | 112 | 110 | 1.9% | 6.1% |
| Korean Won (KRW/$) | 1144 | 1119 | 2.2% | 7.7% |
| US Dollar Index (DXY) | 95.63 | 92.86 | 3.0% | 10.1% |
| **Commodities** | | | | |
| Gold | 1242 | 1269 | 2.2% | 10.2% |
| Oil | 46.0 | 50.2 | 9.0% | -6.6% |
| Natural Gas, Henry Hub | 2.94 | 2.84 | -3.7% | -23.0% |
| Copper (cents/lb) | 270 | 289 | 7.1% | 15.4% |
| CRB Index | 175 | 183 | 4.5% | -5.1% |
| Baltic Dry Index | 901 | 946 | 5.0% | -1.6% |

SOURCE: BLOOMBERG

## Riche Comme un Argentin?

A little more than a century ago, Argentina was one of the wealthiest nations and a magnet for European immigrants. From 1870 to 1913, the Argentine economy grew at an annual rate of 6%, arguably the best in the world during that era. European immigrants flocked to the country's fertile pampas and helped to turn Argentina into the world's leading exporter of corn, flax and meat. In 1912, only seven countries ranked higher than Argentina in per-capita income (New Zealand, the United States, Australia, the United Kingdom, Switzerland, Canada, and Belgium). In that same year, Argentine tango performers toured Europe and kicked off a tango craze in Paris, which soon spread across other major cities across the Continent.

> Let's hope the current bull market has more years left than the dot-com bubble in 1999 and Chuck Prince's dance in 2007.

The influx of immigrants and the growing wealth transformed Buenos Aires into a multi-cultural center with tree-lined boulevards connecting ornate buildings with Baroque, Art Nouveau and Beaux Arts architectural styles. The majestic Teatro Colón (the Colon Theater), opened in 1908 after 20 years of reconstruction, still ranks as one of the world's best opera houses. Wealthy Argentines also graced Europe's capitals and made lavish purchases. In fact, it was the French who coined the phrase "riche comme un argentin" ("rich as an Argentine").

How things have changed since those glory days. The country's exports to Europe were hurt by the First World War that started in 1914. The economy rebounded after the war, but the Great Depression again hit Argentina's exports. The downward spiral accelerated with the military coup d'état in 1930, which kicked off the so-called "Infamous Decade" of economic mismanagement and corruption. Another military coup in 1943 ushered in Peronism, which led to protectionist policies and ruinous inflation. Between 1930 and 1983, Argentine presidents had an average tenure of only two years. It must have been traumatic to live through decades of runaway inflation, depreciating currency and economic mismanagement – Argentina now ranks number one in the world in the number of practicing psychologists per capita. On top of that, the country earned a reputation as a serial sovereign debt defaulter, having defaulted in 1951, 1956, 1982, 1989, 2001 and 2014, not to mention 1827 and 1890 during the 19$^{th}$ century.

## Century Bond

In late 2015, Mauricio Macri was elected the President of Argentina. He wasted no time in tackling the economic malaise left by his Peronist predecessors. Currency controls as well as various export quotas and tariffs were removed. He also negotiated a financial settlement to end the country's default that had started in 2001, paving the way for Argentina to return to the international capital markets.

In June 2017, Argentina accomplished what was previously unimaginable – it issued $2.75 billion of U.S.-dollar denominated ***100-year*** bonds at a yield of 7.91%. The deal was so hot that it attracted orders of $9.75 billion from investors desperately searching for yield.

Judging by Argentina's economic performance and creditworthiness (or the lack thereof) over the past century, one may question the sanity of those who intend on holding the Argentinian sovereign bonds for the next 100 years. However, investors were obviously not focused on the long run. It is rationalized that, with the bond yielding nearly 8%, one could get the capital back in about 12 years. Furthermore, there is the possibility that better economic performance over the next couple of years could drive the value of the bond higher, allowing current holders to sell the bonds for a nice gain.

## Desperately Seeking Yield

Argentine's successful bond offering was emblematic of global investors' growing risk appetite as well as the desperate search for yield in an era of central bank-induced low interest rates. Indeed, emerging market bonds have been getting strong inflows, and the JP Morgan Emerging Market Bond Index (EMBI) has gained 6.9% over the first seven months of 2017. Yield-seeking investors have piled into Eurobonds issued by African countries, too. Merely a month after putting down a military mutiny, the Ivory Coast was able to issue €625 million of bonds maturing in 2025 at 5.125%, and $1.25 billion of bonds maturing in 16 years at 6.125% in June.

In Europe, junk bond yields, as measured by the BofA Merrill Lynch Euro High Yield Index, have collapsed to the lowest on record at *2.51%* yield to worst at the end of July 2017. Yes, a mere 2.51% to own junk bonds. In the riskier leveraged loan market on both sides of the Atlantic Ocean, the so-called covenant-lite ("cov-lite") loans that provide lenders less protection have risen to more than 70% of the market. To put this into perspective, pre-financial crisis in 2007, cov-lite loans had accounted for less than 30% and 8% of the U.S. and European markets, respectively. Moody's issued a warning recently that such a trend "portends lower investor recoveries in the next default cycle." Of course, the operative word here is 'next", which many believe is still a ways off.

### Still Dancing

Ten years ago, on July 9, 2007 to be exact, Chuck Prince, then CEO of Citigroup, when asked about the bank's lending to private equity deals in the face of rising stress in the financial system, said, "*As long as music is playing, you've got to get up and dance; we are still dancing*." It became perhaps the most memorable quote of the era on managerial failures. Prince was ousted four months later as the banking crisis deepened. It is an example that risk could sneak up on even those who make a living dealing with it day in and day out.

To be clear, the macro environment and the financial system today are healthier than in mid-2007, when the subprime bubble was already imploding while many banks were overleveraged. In late June, when commenting on how the Fed has strengthened the banking system and financial stability, Fed Chair Yellen boldly proclaimed, "Would I say there will never, ever be another financial crisis? You know probably that would be going too far but I do think we're much safer and I hope that it will not be in our lifetimes and *I don't believe it will be*." Now that is high conviction!

To us, the Fed Chair's confidence, compressed bond spreads, and record lows in the VIX Index pose an interesting question: are they a true reflection of diminishing risk in the system, or are they raising the systemic risk if and when something goes wrong?

The answer depends on one's time horizon. Near term, the global economy is arguably in the best shape since 2007. On the other hand, as asset valuations and investor complacency become more elevated, the eventual run for the exit during the next recession or crisis could trigger much sharper and more painful sell-offs to accentuate the downturn. Unlike past cycles, the phenomenal growth in passive investing could also wind up being a destabilizing factor. Some exchange traded funds (ETFs) may not have sufficient market liquidity to handle the flood of redemption orders. As a result, it could lead to indiscriminant selling across the board.

The elevated valuations do not necessarily mean that a sizeable market downturn is around the corner, but historically, they have foreshadowed lower prospective returns over the ensuing decade. We are not suggesting a material allocation away from risk assets at this time, but investors need to keep eyes wide open. Some tactical holding of cash may also be advisable, as short-term interest rates have run up to provide positive, albeit still low returns.

Lastly, one more question regarding the Fed Chair's comment of not expecting another financial crisis in our lifetimes – was she subconsciously bearish on human mortality? After all, life is full of surprises, and death is a certainty. As the late Prince (the musician; Chuck is still alive and well) demonstrated, life is rather fragile – he died suddenly in his mansion's elevator at age 57. In his song *1999* (a.k.a. *Party Like It's 1999*), he wrote "*We could all die any day; I don't wanna die; I'd rather dance my life away*." Somehow 1999, dancing, and death collectively reminded me of past financial bubbles and their implosions. Let's hope the current bull market has more years left than the dot-com bubble in 1999, and Chuck Prince's dance in 2007. ●

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# For More Information on Rockefeller & Co:


**ROCKCO.COM** **insights@rockco.co**

**New York, NY**
**10 Rockefeller Plaza**
**3rd Floor**
**New York, NY 10020**
**212-549-5100**

**Washington, DC**
**900 17th Street NW**
**Suite 603**
**Washington, DC**
**20006**
**202-719-3000**

**Boston, MA**
**99 High Street**
**17th Floor**
**Boston, MA**
**02110**
**617-375-3300**

**Rockefeller Trust Company, N.A.**
**10 Rockefeller Plaza**
**3rd Floor**
**New York, NY 10020**
**212-549-5100**

**The Rockefeller**
**Trust Company (Delaware)**
**1201 N Market Street**
**Suite 1401**
**Wilmington, DE 19801**
**302-498-6000**




[1] Index pricing information does not reflect dividend income, withholding taxes, commissions, or fees that would be incurred by an investor pursuing the index return.

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