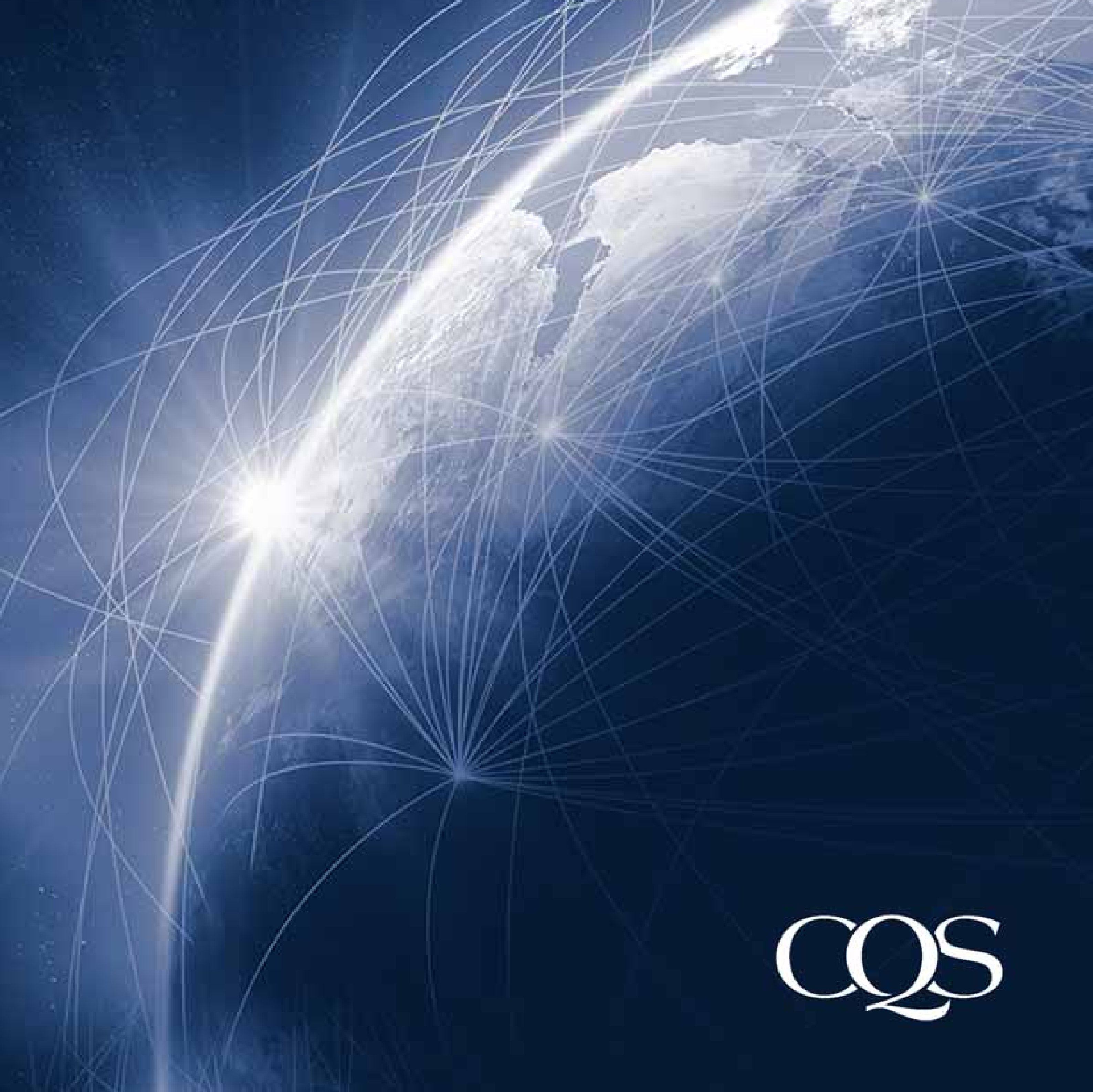
CQS Insights

2015 and Beyond

Sir Michael Hintze

JULY 2015



In this Q&A, Sir Michael Hintze, Chief Executive and Senior Investment Officer of CQS, presents an update on the risks and opportunities he sees in markets in 2015 and beyond.

Q **How do you see the investment environment for 2015 and beyond?**

A I am constructive for markets over the medium-term. I continue to believe that while a US rate rise is a certainty, that rates in Europe and Asia will remain low, central banks will be accommodative and that liquidity will be supportive of markets. As always, there are many crosscurrents globally and there will be increased headline risk and volatility. Importantly, a combination of regulation and central bank intervention has led to market distortions that I believe are driving long-term secular and structural investment opportunities for our investors.

As we go to print, both Greece and China continue to capture the markets' focus. It is difficult to know what the outcome for Greece and the Eurozone will be: it is firmly in the political arena and we are in uncharted waters. What is clear about Greece is that profligate fiscal behaviour has consequences. Whether we eventually have a 'Grexit' or continue to kick the can down the road, there will continue to be headline risk.

The direct exposure of European banking institutions to Greece is modest. As can be seen in Figure 1, aside from Greek banks, direct exposures and the potential impact on Tangible Book Values are modest. Furthermore, in the event of Grexit one might also expect the ECB to inject substantial liquidity into the system in the event of adverse developments.

Figure 1. Total Exposures of European Banks to Greece

Total Exposures	After-tax loss as % of TBV
Eurobank	320%
Alpha	222%
NBG	214%
Pireaus	201%
Cred Ag Group	2%
Deutsche Bank	2%
HSBC	2%
BNP Paribas	1%
Commerzbank	1%
ING	1%
All Other Major European Banks	0%
Foreign banks	1%

Source: Autonomous Research, Company data, EBA, as at 29 June 2015.

Turning to China, it has grown its economic miracle funded in part by debt. Indebtedness can lead to excesses and volatility, and potentially ties the hands of a central government in the long-term. There are market concerns either related to a bubble or correction, but what is clear to me is that there is a slow down in the long-term secular growth rate. I had been expecting GDP growth to slow to below 7% and perhaps as low as 5%. I had also expected US GDP growth to take up the slack from a global economic perspective. Few had anticipated the extent of the rally in Chinese markets and the rapidity of their decline.

The key thing is to understand the potential for contagion into the broader financial markets. Both Greece and China are serious matters which, in extremis, are clearly tail-risk events. We are monitoring developments carefully. I also continue to be mindful of an array of geopolitical fracture points that have the potential for transmission into the global financial system.

Q **How do you see the global economy performing?**

A In terms of the economy, global GDP appears to be heading for 2.6% growth in 2015 and 3.3% in 2016. US growth is forecast to pick up from 2% in 2015 to 2.5% in 2016 and growth in the EU from 1.7% to 2.4%. I find it interesting that the economies in Portugal, Spain and Ireland are seeing vigorous rebounds, and Germany and the UK continue to be positive. AsiaPac is forecast to see growth of 4.7% and 5.1% in 2015 and 2016, respectively, Japan is forecast to grow 1% and 1.5% in 2015 and 2016 nevertheless the slow down in China could result in more modest rate for Asia Pac as a whole.[1]

Q **Are you concerned about inflation?**

A While some commentators argue that there is a growing risk of wage-push inflation in the US, I believe there are structural changes to energy supplies and in the work place that mean inflation may well be muted in the medium-term.

Source: [1]J.P. Morgan, Global Asset Allocation, 22 March 2015.

One should not confuse productivity and price deflation. While the US and UK labour markets are tightening, unemployment rates in large parts of the EU remain high. Figure 2 shows that while wages and salaries are rising, average hourly earnings remain muted.

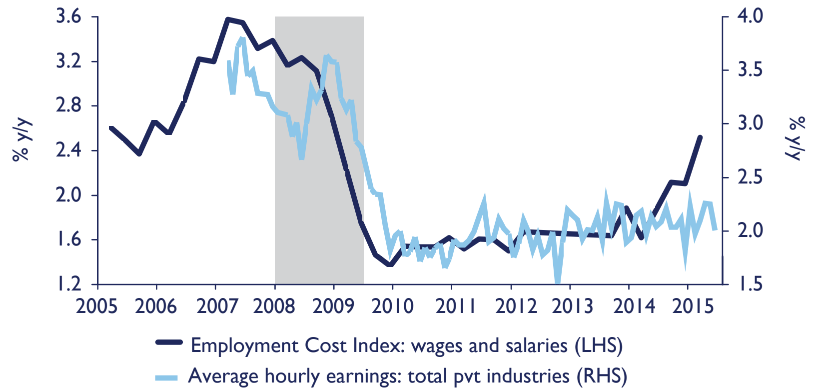
Importantly, labour productivity growth in most developed economies has been low. In the US, labour productivity has grown by just 1.5%[2]. From what I can see, it is a puzzle to central banks. I believe that this is due to the growing proportion of the services' sector share of GDP as illustrated by Figure 3. My sense is that it is difficult to measure the productivity of some of the most dynamic parts of our economy, such as social media. How can we fully capture the economic activity associated with apps and with Facebook? This is also true of robotics, artificial intelligence and biotechnology; Moore's Law is at work.

Q ...And in the natural resources and commodities markets?

A I will not dwell on energy, given our recent CQS Strategy Perspective 'Is this the End of OPEC' in which we laid out our views on why the oil price is likely to remain in a range of US$30 to $60 per barrel. Another important factor is the Iran/US deal. One of the main sources of oil supply is Iran. I would suggest that a deal could be a quid pro quo for allowing Iran's Revolutionary Guard to lead the front against Islamic State. It may not only be on nuclear, but also enable Iran to export its oil. Consequently, I believe there will be more downward pressure on the oil price and there is more downside risk to Brent than WTI. Overall, the consequence will be a massive change to the energy value chain including in the energy-related credit and equity sectors. As it relates to resources more broadly, my view remains that the slowdown in China's growth rate will continue to challenge pricing of industrial commodities.

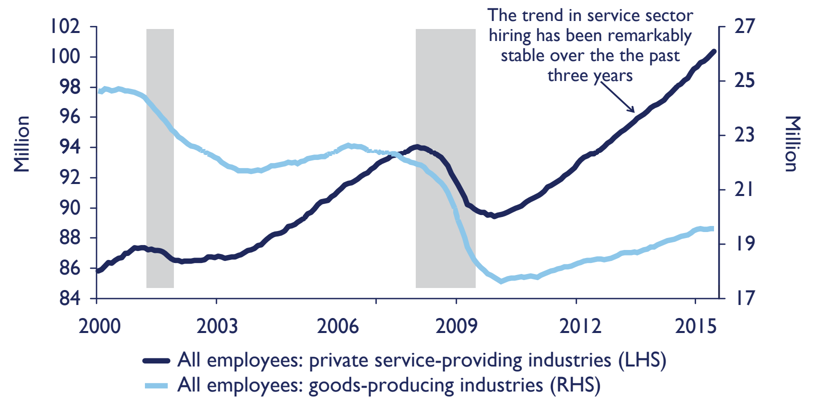
Source: [2]Goldman Sachs Global Macro Research June 2015.

Figure 2: Average Hourly Earnings Growth Trailing Total Wages and Salaries



Source: BLS, DB Global Markets Research, July 2015.

Figure 3: US Services Jobs Driving Recovery in Total Employment



Source: BLS, DB Global Markets Research, July 2015.

Q There is a clear divergence in global monetary policies. What are your thoughts on what this means for markets?

A We are beginning to see some normalisation of monetary policy in the US and the UK, while there is ongoing QE in the euro area, Japan, China and potentially South Korea.

This has been initially expressed through currencies and we have seen competitive devaluation. While the US dollar has weakened against the yen and euro over the last quarter, it should continue to be firmer over the medium-term. The end of QE in the US has also resulted in divergence within and across markets, providing us with greater opportunity.

Until June 2014, QE and Forward Guidance had been driving markets into the same trade and there had been a convergence of spreads and valuations. In July 2014 that began to change. However, it is still a highly technical market.

As I have written previously, it is not the all-in yield that is most relevant, but rather the spread over the risk-free rate. Credit spread is a function of the probability of default times the loss given default plus a 'illiquidity' premium.

In certain sectors, such as energy, we are seeing an increase in the default rate, but overall default rates remain moderately low. Furthermore, if one isolates the risk-free rate, current credit spreads are not dissimilar to those that I encountered in the market when I joined Salomon Brothers in 1982 when the Fed funds rate and T-bond yields were considerably higher. I believe our disciplined approach to fundamental analysis will continue to enable us to find relative value across capital structures and across sectors.

Q What are your thoughts regarding a Fed hike?

A It is clear the next move in US rates will be up. However, I believe Governor Yellen will be behind the curve. I think it is almost certain there will be a US rate hike by the end of Q1 2016; my sense is that there is a 60% chance it will take place in September 2015 and a 40% chance it will be at the end of Q1 2016. Liquidity will not be withdrawn in the US but increased economic activity will replace monetary stimulus. Conversely, the European Central Bank (ECB), People's Bank of China (PBoC) and the Bank of Japan (BoJ) continue with Quantitative Easing (QE) policies. I believe a Fed rate hike has been largely discounted, but the timing may still surprise if the rise comes early. However, when rates do rise they will do so gently.

Q You have spoken in the past about QE resulting in the disruption of the markets as a signalling mechanism. What are your present thoughts?

A That's a timely question. QE and Forward Guidance have led to a highly technical market. QE has disrupted the market's signalling and liquidity has also been affected by central bank asset purchases. The substantial decline in proprietary trading due to Dodd Frank has also exacerbated volatility. For instance, while a major market move would have almost certainly taken place, I believe that the dramatic moves we saw following the move by the Swiss National Bank to unpeg the Swiss franc from the euro in January were exaggerated by a lack of liquidity. These distortions are also creating gap risk. By this I mean that there can be significant price movements without much trading activity and this can lead to mark-to-market volatility. That is not always a happy place for investors or asset managers.

One could argue that regulation – Basel III in particular – has led to a situation where we have too much solvency and not enough liquidity, which is in contrast to before the financial crisis when there was too much liquidity and not enough solvency. These are not the only distortions. There is significant risk from unintended consequences arising from regulation of insurers and banks.

Of particular concern is the difficulty of the operation of Repo and the problems associated with wholesale bank deposits. For example, the Repo market in the US has shrunk from $6.5tn in 2008 to around $4.2tn in 2014.[3]

While partly driven by pricing, changes to market structure are at play. Elsewhere bid/offer spreads on an LCS basis (liquidity cost scores) have widened 80% in investment grade and 20% in high yield, reflecting the difficulty and increasing cost of dealing.

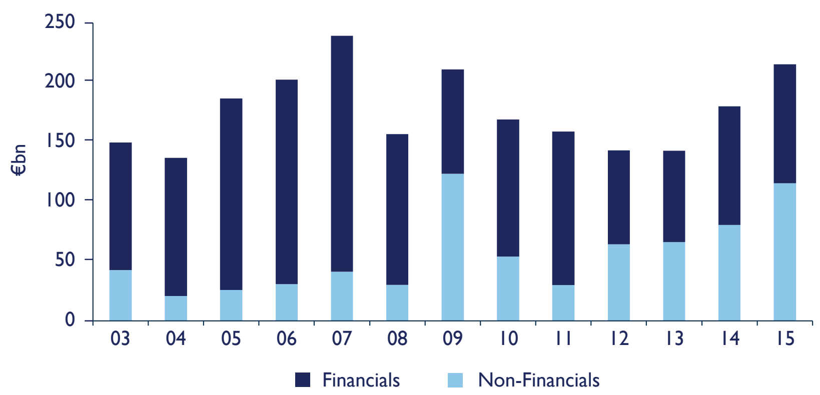
We are incorporating this in our risk analysis. It is, however, difficult to be definitive about it as we are in uncharted waters.

Q Can you elaborate on what is driving long-term secular and structural investment opportunities?

A Bank disintermediation is taking place. Simon Finch, our CIO of Credit, posited in 2011 that we would see material growth in European debt capital markets as banks sought to comply with Basel III capital requirements. Figure 4 illustrates the significant growth in non-financial issuance in the euro market. There is an increasing shift from bank lending to capital markets funding leading to broader and deeper markets. While this is well established in US credit markets, it is a growing trend in Europe and one which we think will continue.

Figure 4: Euro Non-Financial Issuance Up Significantly

A Broader, Deeper Market: Shift From Bank Lending to Capital Markets

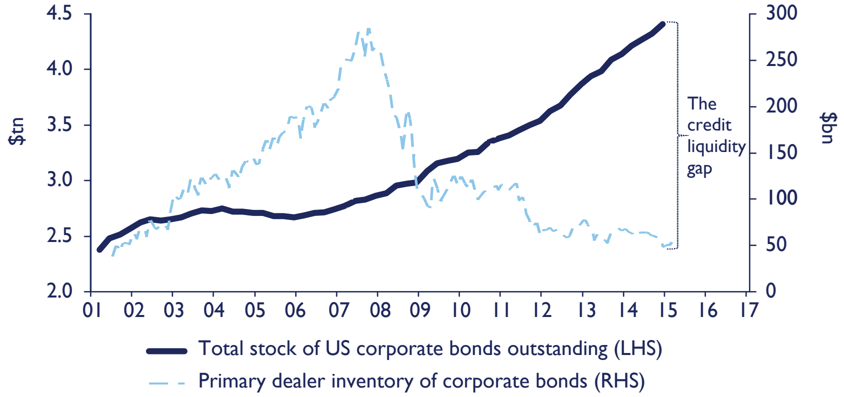


Source: Citi Research, Dealogic, 17 April 2015. Euro Investment Grade.

Source: [3]Sifma, US Repo and Reverse Repo Data, 7 July 2015.

Figure 5: Primary Dealer Inventories of Corporate Bonds

Primary Dealer Inventories of Corporate Bonds Have Dropped as Bond Market Volume Has Risen



Source: FRB, Haver Analytics, DB Global Markets Research, as at April 2015.

Banks are increasingly 'risk off'. There is less competition and volatility in markets increasing. Although a crude tool, looking at Primary Dealer Inventories of corporate bonds provides a clear picture of the magnitude and direction of the 'liquidity gap'. Figure 5 shows how much bank inventories of corporate bonds have dropped while at the same time market volume has risen.

We believe this trend in declining liquidity is set to continue. From an investor's perspective regulation, complexity and illiquidity provide us returns across the credit spectrum and we are seeking to capture the 'illiquidity premium'. We see a rich opportunity set, particularly in Europe, across sectors such as structured credit, CLOs, European CMBS and RMBS, stressed/distressed and illiquid credit as European banks reduce balance sheets and scale down non-core assets. European CLOs are an example of how regulation is creating distortions. EU Directives introduced the 'skin-in-the-game' retention requirements for CLOs and the delivery of loan funds to the retail investors impossible or extremely expensive by the UCITS Directive.

The consequence of this is that European senior secured loans are trading at a yield premium to high yield – you can go up the capital structure at low or no cost. Interestingly, concerns regarding the introduction of 'skin-in the-game' legislation in the US are weighing on that market.

Conclusion

I am constructive for markets in the medium-term. Bank regulation and solvency requirements are having and will continue to have an effect on markets and liquidity. Furthermore, I anticipate greater dispersion and a more volatile market environment subject to greater headline risk.

I am optimistic that we will continue to be able to find opportunity from this disruption, both on the long and short sides, for the benefit of our investors.

I am confident that we have the skill sets and the research capabilities to identify relative value across the capital structure and between sectors, to trade and risk manage positions effectively and to trade nimbly.

Sir Michael Hintze
Chief Executive and
Senior Investment Officer

About the Author

Sir Michael is the founder, Chief Executive and Senior Investment Officer. He is also a Senior Portfolio Manager.

Prior to establishing CQS, Michael was Managing Director in the Leveraged Funds Group at CSFB where he developed the strategy and management team for the CSFB Convertible & Quantitative Strategies Fund, which later became CQS' Convertible Arbitrage offering. Before this, Michael was Managing Director and European Head of Convertibles at CSFB, responsible for flow and proprietary trading, sales and research.

Before joining CSFB in 1996, Michael worked at Goldman Sachs for 12 years in a variety of roles including Head of UK Equity Trading. From 1984 to 1992 he established and built up Goldman's Euro Convertible and European Warrants business in London. During this period he was also a Consultant for Goldman Sachs on the Markets Development Committee of the London Stock Exchange to report on new market structure (SETS) and was both Vice Chairman and Chairman of the Euro Convertible and European Warrants Committee of ISMA. In addition to these roles, Michael also represented Goldman Sachs on a number of other finance industry committees including several LSE committees.

Prior to joining Goldman Sachs in 1984, Michael worked for Salomon Brothers in New York as a Fixed Income Trader trading Yankee Bonds having completed the firm's Graduate Training Program in 1982.

Michael served for three years in the Australian Regular Army finishing as a Captain in the Royal Australian Electrical and Mechanical Engineers.

After the Army he worked as an Electrical Design Engineer for Civil and Civic Pty Ltd in Australia.

Michael has significant and wide-ranging philanthropic interests and to consolidate these, the Hintze Family Charitable Foundation was established. Since inception in 2005, almost 200 charities have received funding from the Foundation.

Michael is a fluent Russian speaker. He holds a BSc in Physics and Pure Mathematics and a BEng in Electrical Engineering both from the University of Sydney. He also holds an MSc in Acoustics from the University of New South Wales, an MBA from Harvard Business School and received a Doctor of Business and an Honoris Causa from the University of New South Wales.

About CQS

Founded in 1999, CQS is a $13.8bn[1] global multi-strategy asset management firm with 270 staff located globally[2], 86 of whom are specialist investment professionals[2]. CQS launched its first fund in March 2000 and has expanded its offering to include additional strategies and bespoke solutions in the areas of multi-strategy, convertibles, asset backed securities, credit, loans and equities.

Since inception, fundamental analysis has been placed at the heart of the firm's investment process. The investment teams follow a collaborative multi-disciplinary approach seeking adjacencies across all areas in which the firm invests. CQS' robust operations and risk management platform provides all mandates with liquidity management and risk monitoring, enabling investment professionals to be more nimble and effective throughout all market environments.

A founding member of the Hedge Fund Standards Board, CQS is regulated by the FCA in the UK, the SFC in Hong Kong, ASIC in Australia and registered with the SEC in the US, with a presence in the Channel Islands, Cayman Islands and Luxembourg.

Source: [1]CQS estimated as of 1 July 2015. [2]CQS as of 30 June 2015.

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