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The Aerial View

Fixed Income & Markets Update

Looking at the Laggards

- **Amid 2018's very rich asset valuations, taking a look at laggards from previous years could be instructive for investors**
- **Buying 2015's weakest performers turned out to be a good strategy in 2016**
- **But 2017's year-long rally produced much more mixed results as 2016's stragglers continued to lag behind**

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By now, enough has been written about the many superlatives served up in 2017.

Risk assets outperformed almost all expectations at the start of the year, with most global equity markets reaching record highs at some point during the past 12 months. Double digit gains were not uncommon for equity bourses, although a late surge in US stock valuations pushed broad gains above 20%, which led the developed markets.

Credit gains were also impressive, with 6-7% total returns that were primarily driven by spread tightening that lowered risk premiums back to pre-crisis lows. While global yields were generally higher, US rates were punctuated by a 100 bps flattening of the 2s30s curve, driven by the 70 bps increase in 2y yields and the 33 bps decline in 30y yields.

Rich Valuations

Last year's strong gains have nonetheless created a common lament regarding rich valuations, with both credit spreads and equity valuations considered stretched by historical standards.

If the first week of 2018 trading is any gauge, those valuations can get even richer, buoyed by additional central bank liquidity, expectations of continued strong economic performance globally and scarcity value as central bank balance sheets continue to grow.

Not only have we hit new all-time highs in equities, but credit spreads are at levels last seen in 2007. Meanwhile EM flows have been overwhelmingly positive, all despite the strong returns posted last year.

To say value investing has become more challenging over the past year is an understatement. We suspect that investors are applying a “dogs of the Dow” philosophy in evaluating asset classes that may be set for outperformance this year.

Sector Returns, by Quartile 2015-2017 (Investment Grade)

	2015	Total Returns	Excess Return	Total Vs Index	2016	Total Returns	Excess Return	Total Vs Index	2017	Total Returns	Excess Return	Total Vs Index
4th Quartile	Basic Industry	-7.32	-8.37	-6.64	Banking	3.55	2.40	-2.56	Finance Comp.	5.11	2.85	-1.31
	Energy	-7.03	-8.01	-6.35	Consumer Noncyclical	4.71	3.53	-1.40	Banking	5.15	3.23	-1.27
	Utility	-1.47	-2.03	-0.79	Reits	4.74	3.46	-1.38	Capital Goods	5.38	2.34	-1.04
3rd Quartile	Communications	-1.28	-2.05	-0.59	Brokerage Asset Mgr	4.80	3.50	-1.32	Reits	5.70	3.61	-0.72
	Transportation	-0.69	-1.37	-0.01	Capital Goods	4.85	3.62	-1.27	Consumer Cyclical	5.82	3.04	-0.60
	Consumer Cyclical	0.19	-0.79	0.87	Insurance	5.28	3.94	-0.83	Technology	5.98	3.05	-0.44
	Technology	0.31	-0.66	1.00	Consumer Cyclical	5.32	3.93	-0.79	Brokerage Asset Mgr	6.27	4.24	-0.15
2nd Quartile	Insurance	0.36	-0.48	1.04	Technology	5.65	4.61	-0.46	Consumer Noncyclical	6.30	3.04	-0.11
	Capital Goods	0.56	-0.38	1.24	Finance Comp.	6.01	3.40	-0.11	Communications	7.19	3.56	0.77
	Consumer Noncyclical	0.81	-0.10	1.49	Utility	6.03	4.83	-0.08	Energy	7.44	4.34	1.03
	Reits	1.44	0.05	2.12	Transportation	6.83	5.72	0.72	Transportation	7.52	3.29	1.10
1st Quartile	Finance Comp.	1.68	0.80	2.36	Communications	7.02	5.80	0.90	Utility	7.59	3.41	1.17
	Brokerage Asset Mgr	1.74	0.52	2.42	Basic Industry	13.72	12.81	7.61	Insurance	7.83	4.35	1.41
	Banking	1.74	0.69	2.43	Energy	13.86	12.86	7.75	Basic Industry	10.20	6.81	3.79

Source: Bloomberg, Bloomberg/Barclay Indices

For instance, broadly speaking, high yield lagged investment grade in 2017, particularly from a risk-adjusted perspective. As the credit environment improved at the end of the year after its October widening, that underperformance was obvious as IG posted a +0.9% total return in December versus a gain of only +0.3% for high yield.

The reach for yield was, however, evident at the start of the year, as the HY index has already tightened 25 bps, led by the 40+ bps tightening in the triple-C sleeve, versus the 1 bps tightening in IG land.

2015 Laggards Performed Strongly in 2016

With this in mind, we decided to look at the y/y performance of some of the best and worst-performing asset classes and sectors over the past few years. In 2016, buying the weakest performers from 2015 proved to be a good strategy.

The broad global macro themes in 2015 were largely driven by monetary policy divergence and mixed economic performance. That year, we largely saw USD strength and oil price weakness generate losses for all energy market sectors. As a result, energy and basic materials were the weakest performing debt and equity sectors in 2015.

They subsequently reversed their bottom performing position in 2016 as the commodity complex recovered 80% of its prior year losses. Global central banks also added to the overall market liquidity, growing their balance sheets by almost $1 trillion in 2016, despite the Fed continuing to raise rates, albeit slowly.

Therefore, within the S&P, the energy sector was almost flat over the 2015-2016 periods, with a

24% decline in 2015 offset by a 24% increase in 2016. Buying the laggards proved a better strategy in credit, with HY energy posting -19% of excess returns in 2015, which reversed to +20% in 2016.

2016 Laggards Continued to Dawdle in 2017

2017's melt up, however, proved to be more challenging for this strategy, with far more mixed results. For instance, while HY banking went from last to first, consumer staples and REITS were laggards in both 2016 and 2017, as the attached table illustrates. Equity sectors told a similar story, with only one of the three worst-performing groups near the top quartile in the following year.

Sector Returns, by Quartile 2015-2017 (High Yield)

	2015	Total Returns	Excess Return	Total Vs Index	2016	Total Returns	Excess Return	Total Vs Index	2017	Total Returns	Excess Return	Total Vs Index
4th Quartile	Energy	-25.11	-19.08	-19.33	Banking	3.90	2.88	-13.23	Communications	5.01	3.58	-2.49
	Basic Industry	-18.87	-13.10	-13.10	Consumer Non-Cyclical	6.36	4.87	-10.77	Finance Companies	6.43	5.38	-1.07
	Utility	-6.53	-0.69	-0.76	REITS	8.06	6.94	-9.07	Consumer Cyclical	6.65	5.33	-0.86
3rd Quartile	Communications	-3.13	2.73	2.64	Transportation	9.99	8.80	-7.14	Technology	7.31	5.99	-0.19
	Transportation	-1.79	3.99	3.98	Insurance	10.29	8.70	-6.84	REITS	7.39	6.14	-0.11
	Capital Goods	-1.07	4.55	4.71	Finance Companies	12.05	10.81	-5.08	Consumer Non-Cyclical	7.49	6.12	-0.02
	Insurance	-1.22	4.57	4.55	Consumer Cyclical	12.09	10.64	-5.04	Energy	7.72	6.18	0.22
2nd Quartile	Technology	-0.45	5.17	5.33	Capital Goods	13.33	11.91	-3.80	Capital Goods	8.65	7.32	1.15
	Finance Companies	0.30	6.02	6.07	Utility	13.85	12.44	-3.28	Insurance	8.91	7.51	1.41
	Consumer Cyclical	0.43	6.13	6.20	Communications	14.18	12.73	-2.95	Basic Industry	10.21	8.61	2.71
	Consumer Non-Cyclical	0.95	6.58	6.72	Technology	15.70	13.75	-1.43	Brokerage Asset Managers	11.01	10.04	3.51
1st Quartile	Brokerage Asset Manager	2.04	7.87	7.81	Brokerage Asset Managers	16.94	15.66	-0.19	Utility	11.82	10.40	4.32
	Banking	3.12	8.85	8.90	Basic Industry	36.48	35.34	19.35	Banking	12.12	10.18	4.61
	REITS	4.84	10.77	10.61	Energy	37.37	36.07	20.24	Transportation	12.33	11.24	4.82

Source: Bloomberg, Bloomberg/Barclay Indices

With these imperfect results as a backdrop, looking at the laggards in 2017 shows a far narrower dispersion than in prior years. Communications proved to be the weakest HY group in 2017, a spot it obtained with a 2.5% underperformance to the broad benchmark. This compares to -25% for energy in 2015 and -13% for banking in 2016.

This speaks to the relatively narrow spreads with which credit ended 2017, which has ultimately become tighter at the start of the year. We will note that equity sectors did have wider differentials, with telecom and energy the laggards in 2017, while only energy has become a leading sector so far in 2018.

Currencies

As far as other asset class trends are concerned, the USD had its worst year since 2003 in DXY terms. The majors were the strongest performers versus the dollar, with the EM currency index posting a +6% gain versus the 14% gain of EURUSD.

From a yield perspective, the bifurcation of curve was most pronounced in Treasury securities, with short yields rising 70 bps, while long yields fell 33 bps. In contrast, Bund yields were between 16 bps and 32 bps higher in 2017, with yields higher across the curve. The only DM sovereign markets that saw their curves bifurcate in a similar manner to Treasuries were UK and Canadian government bonds.

These countries also proved to be the only large economies to tighten credit conditions, an obvious link that also led to a flattening of their curves. Sovereign yields have been mixed since the start of the year, with the only discernable pattern of risk taking driving periphery yields lower. The broad expectations of additional curve flattening remains widespread, but has yet to establish itself this year.

Using laggards as a proxy for current year performance has proven mixed over the past few years. In fact the initial week of trading in 2018 indicates a continuation of the momentum, with sector and market leaders pushing to their Y/E strength.

Whether rates investors prove prescient in forecasting economic performance sets up an interesting intersection, as the flatter curve, which very much defined the goldilocks' scenario of better growth, amongst low inflation has not yet established itself this year.

2017 - A very Good Year for Risk Assets As of: Dec 29, 2017

Currencies	**2015**	**2016**	**2017**	**Stocks**	**2015**	**2016**	**2017**
USD (DXY)	-6.4%	-2.3%	-8.7%	DJIA	8.0%	16.0%	25.4%
Euro	8.6%	3.7%	12.7%	SP500	8.2%	10.7%	19.9%
Japanese Yen	4.1%	-1.0%	3.2%	NASDAQ	14.1%	13.3%	29.4%
GB Pound	5.6%	2.6%	8.5%	Stox 50	4.6%	3.3%	7.9%
Canadian Dollar	3.7%	1.5%	5.1%	FTSE	2.4%	3.8%	6.3%
Russian Ruble	5.4%	0.2%	5.5%	Dax	7.4%	6.0%	13.8%
South African Rand	4.9%	3.8%	8.2%	Nikkei	4.8%	14.3%	19.8%
Brazilian Real	-1.7%	-0.5%	-1.9%	Hang Seng	17.1%	14.8%	34.4%
Mexican Peso	14.3%	-7.1%	6.2%	Bovespa	4.4%	19.3%	24.4%
Bonds (bp Change)	**2015**	**2016**	**2017**	**Commodity**	**2015**	**2016**	**2017**
US 2-Year	19	50	70	Oil (WTI)	-16.5%	22.3%	2.0%
US 10-Year	-14	18	4	Oil (Brent)	-14.6%	29.3%	10.2%
Bunds 10-Year	26	-5	21	Gold	8.2%	2.3%	10.5%
UK 10-Year	2	-2	0	**Corporates**	**2015**	**2016**	**2017**
JGB 10-Year	4	-4	0	IG Spreads	-14	-15	-29
Spain 10-Year	14	-7	8	Junk Spreads	-45	-21	-66
US 2s vs 10s	-33	-32	-66	**Volatility**	**2015**	**2016**	**2017**
US 5s vs 30s	-19	-36	-54	Vix	-20.4%	-14.7%	-32.4%
US 10Y Breakevens	-23	22	-2	MOVE FI Index	-22.9%	-6.5%	-28.0%

Source: Bloomberg

Please direct questions or comments to:

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