Camdor GLOBAL

FINDING LASTING SOLUTIONS IN AN UNCERTAIN WORLD

CAVEAT INVESTOR

Coping with negative rates, deglobalisation and the challenges ahead

Dr Bob Swarup

PRINCIPAL, *Camdor Global*

AUTHOR, *Money Mania*

Copyright © 2016 Camdor Global All rights reserved.

Why bother?

The only point of economic forecasting is to make astrology look respectable.

J.K. Galbraith

Logic: The art of thinking and reasoning in strict accordance with the limitations and incapacities of the human misunderstanding.

Ambrose Bierce

The only thing worth globalizing is dissent.

Arundhati Roy

Copyright © 2016 Camdor Global All rights reserved.

An uncertain world

- An environment dominated by policymakers and uncertainty
- Questions abound:
    - Will Brexit be hard or soft?
    - Will Europe escape deflation?
    - Will China end up as the latest poster child for the perils of debt fuelled growth?
    - Is US growth sustainable?
    - How do we exit quantitative easing?
    - How big can a central bank or sovereign balance sheet get?
    - The challenge of regulation
    - Social tensions

Copyright © 2016 Camdor Global All rights reserved.

The Moses Principle

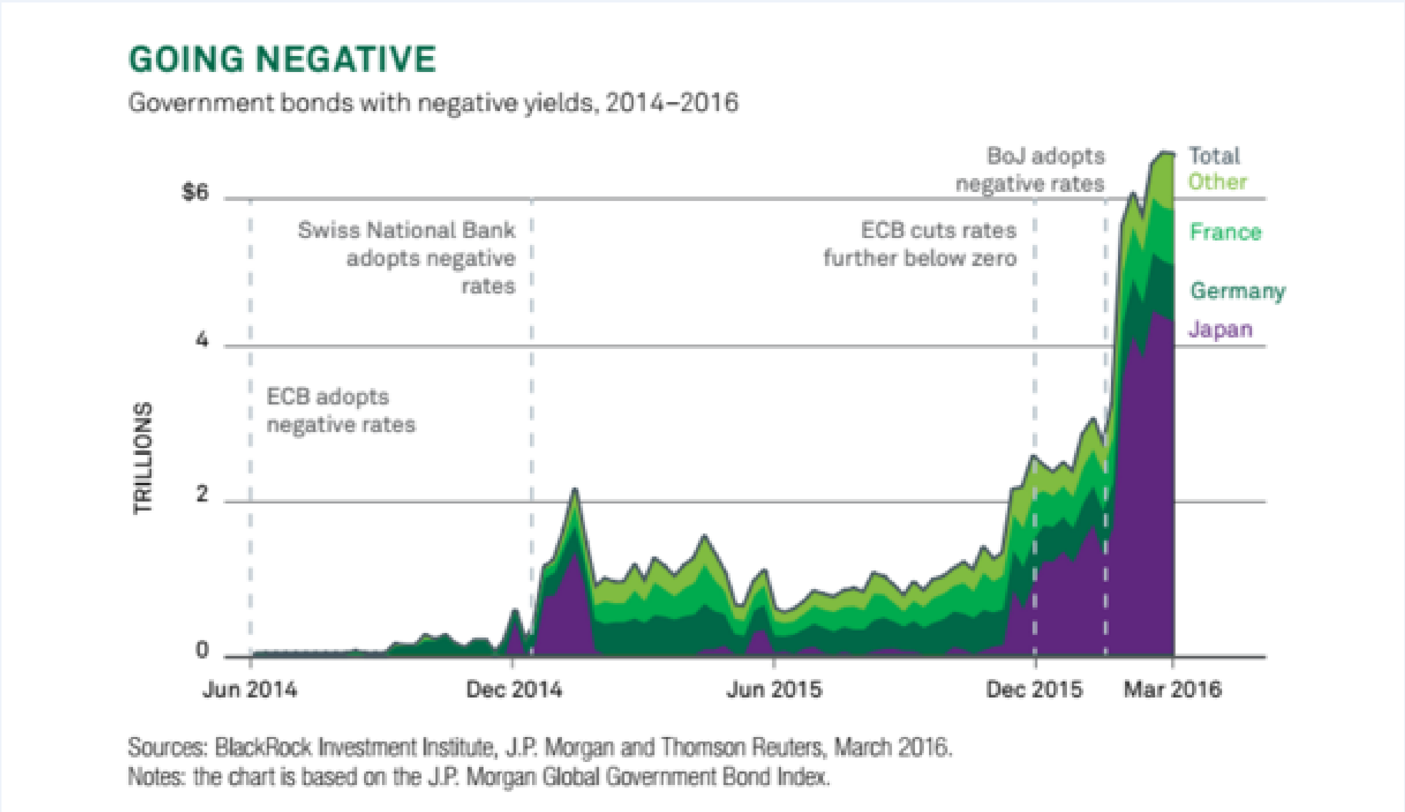
- Why did the Jews spend forty years in the desert?
- The land of ‘Milk and honey’?

- A metaphor for generational change
- As the old died out, so did their memories of Egypt
- Most Israelites would have been born in the desert

- Today, the Moses Principle lives on…
  - The world economy
  - Investors
  - Policymakers

Copyright © 2016 Camdor Global All rights reserved.

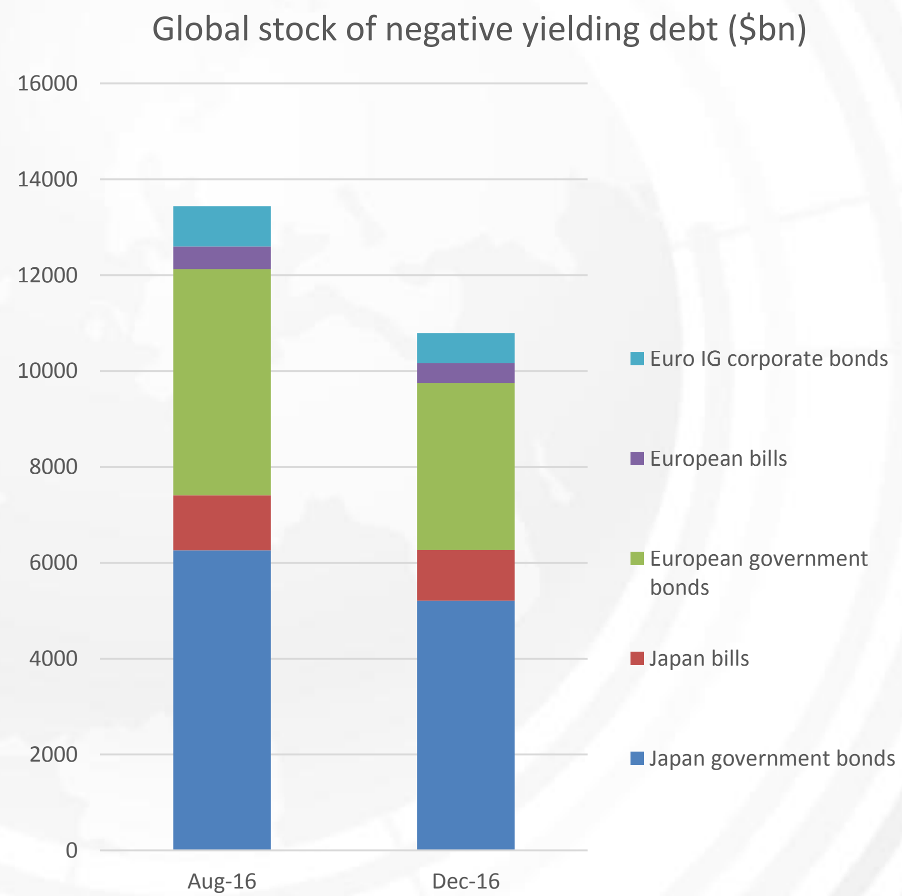
Onto negative rates…



Copyright © 2016 Camdor Global All rights reserved.

More recently…

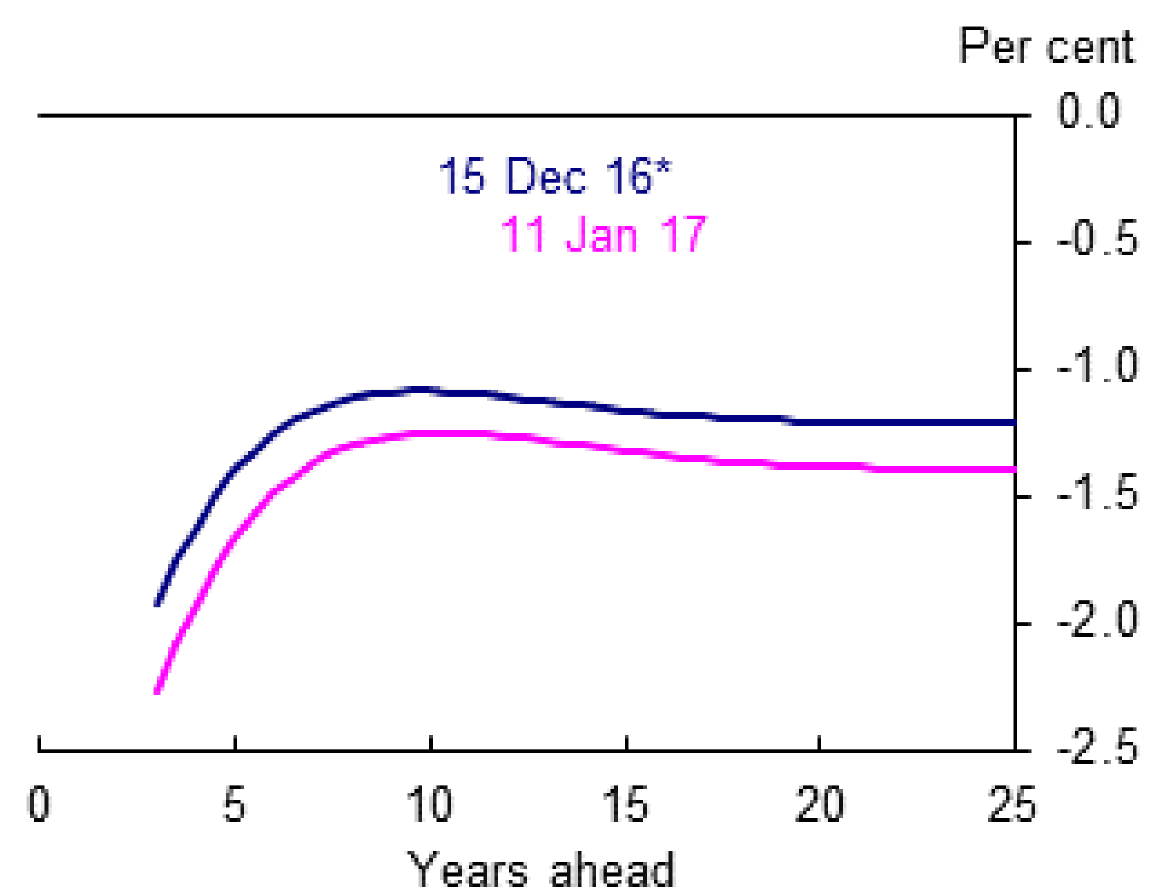
- The benefits of Donald Trump



Copyright © 2016 Camdor Global All rights reserved.

What about real rates?

- A far greater problem for liability driven investors

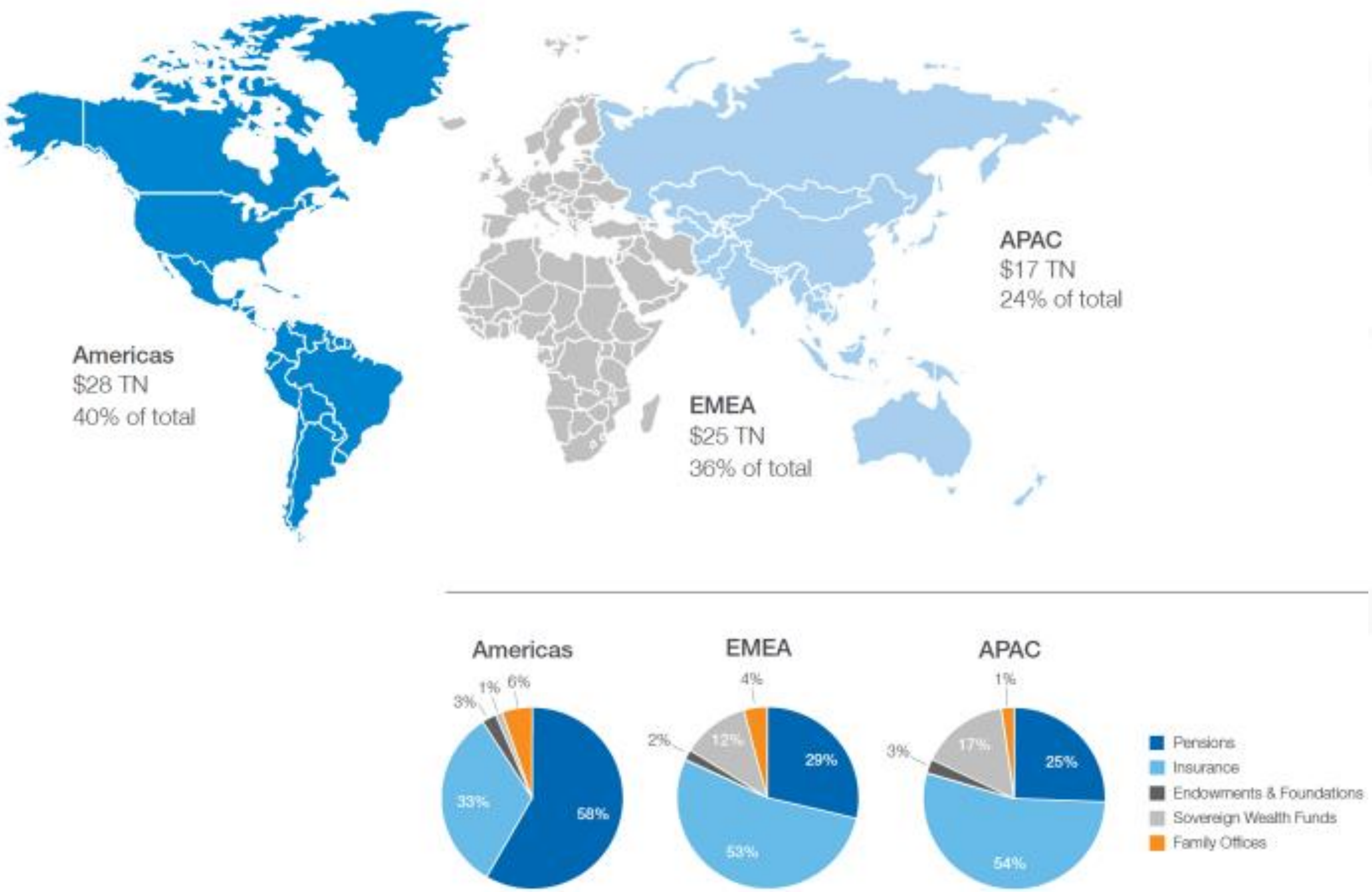


Source: Bank of England

Copyright © 2016 Camdor Global All rights reserved.

The really big pools of capital

Figure 14: Estimated total global institutional assets under management as of 2013: $70 trillion



Source: Oliver Wyman Global Asset Model

Copyright © 2016 Camdor Global All rights reserved.

Liability-driven investors face numerous challenges today

Balance sheet/funding level volatility all important

The search for yield

Extensive risk management required

Look through of asset pools to underlying

Negative real returns and depleting asset portfolios

What do you do?

Tail risks

What about diversification?

Risk vs uncertainty

Unstable correlations

Growing regulation

The rise of geopolitics and sociopolitics

Copyright © 2016 Camdor Global All rights reserved.

The strengthening dollar

- Strong US dollar is a drag on growth - equivalent to monetary tightening through the back door
- 1937? What about EM debt and its repercussions?

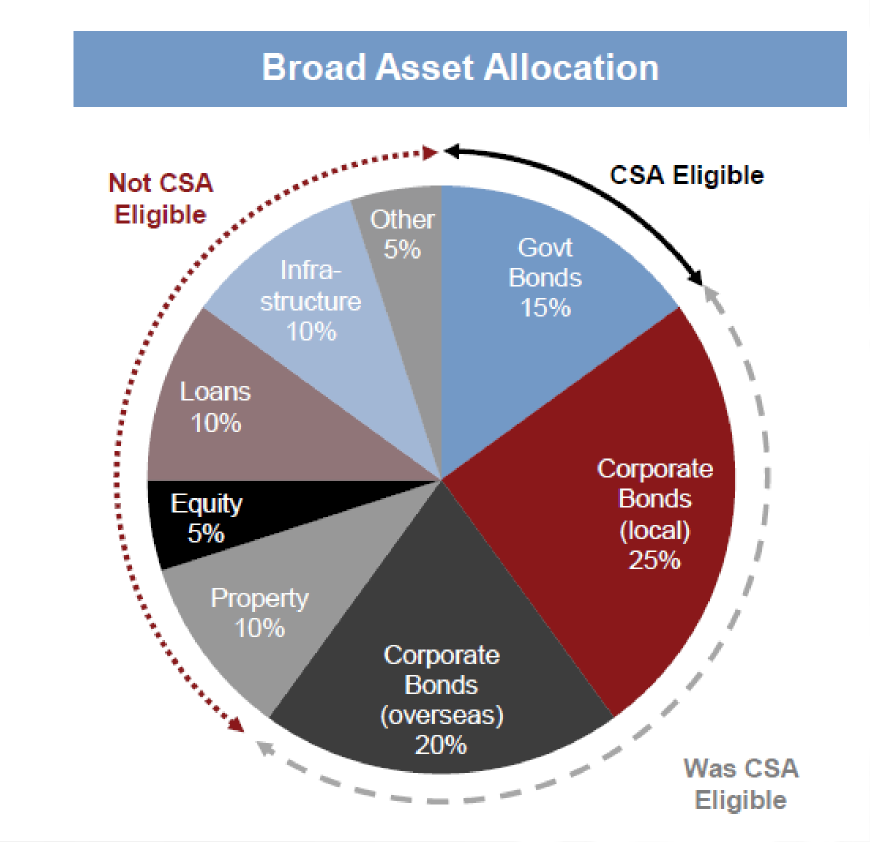
Copyright © 2016 Camdor Global All rights reserved.

What about liquidity?

- Corporate bond liquidity has reduced by circa 70% since the 2008 financial crisis
- Regulators are focussed on solving systemic risks in banking and elsewhere rather than the wider capital markets
- Retail investors are a larger part of the corporate bond market than pre-financial crisis. It is likely this money will be more “flighty” in a market crisis

Copyright © 2016 Camdor Global All rights reserved.

In a world of cash, we have less collateral than ever



- We all love derivative overlays, but few assets provide eligible collateral for clearing
- And those that do are loved by both central banks and institutions

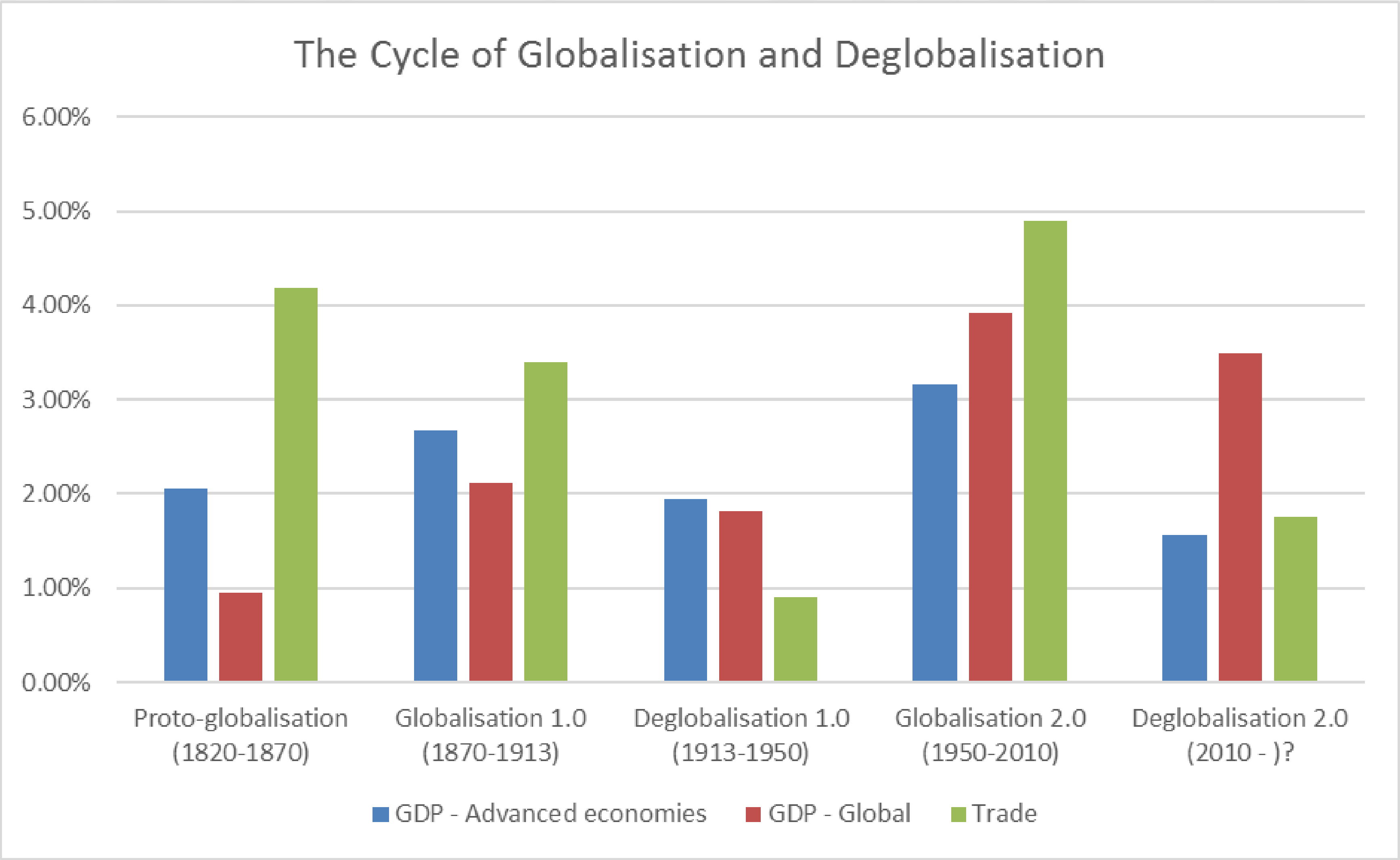
Copyright © 2016 Camdor Global All rights reserved.

The meme of globalisation

- An assumption we all take for granted
- But the underlying can change and flocks can move in new directions
- What is globalisation?
- Globalisation
  - The economic state where trade across nations (exports and imports) is growing faster than GDP
  - People interact more, transact more and create more wealth through their exchanges.
  - Also a growth in debt and inequality
- Deglobalisation?
  - By opposition, the alternate state where trade grows less than GDP
  - Countries become inward focused, international trade declines as a proportion of GDP and growth slows down as economic opportunities shrink
  - By implication, deleveraging and higher returns to labour

Copyright © 2016 Camdor Global All rights reserved.

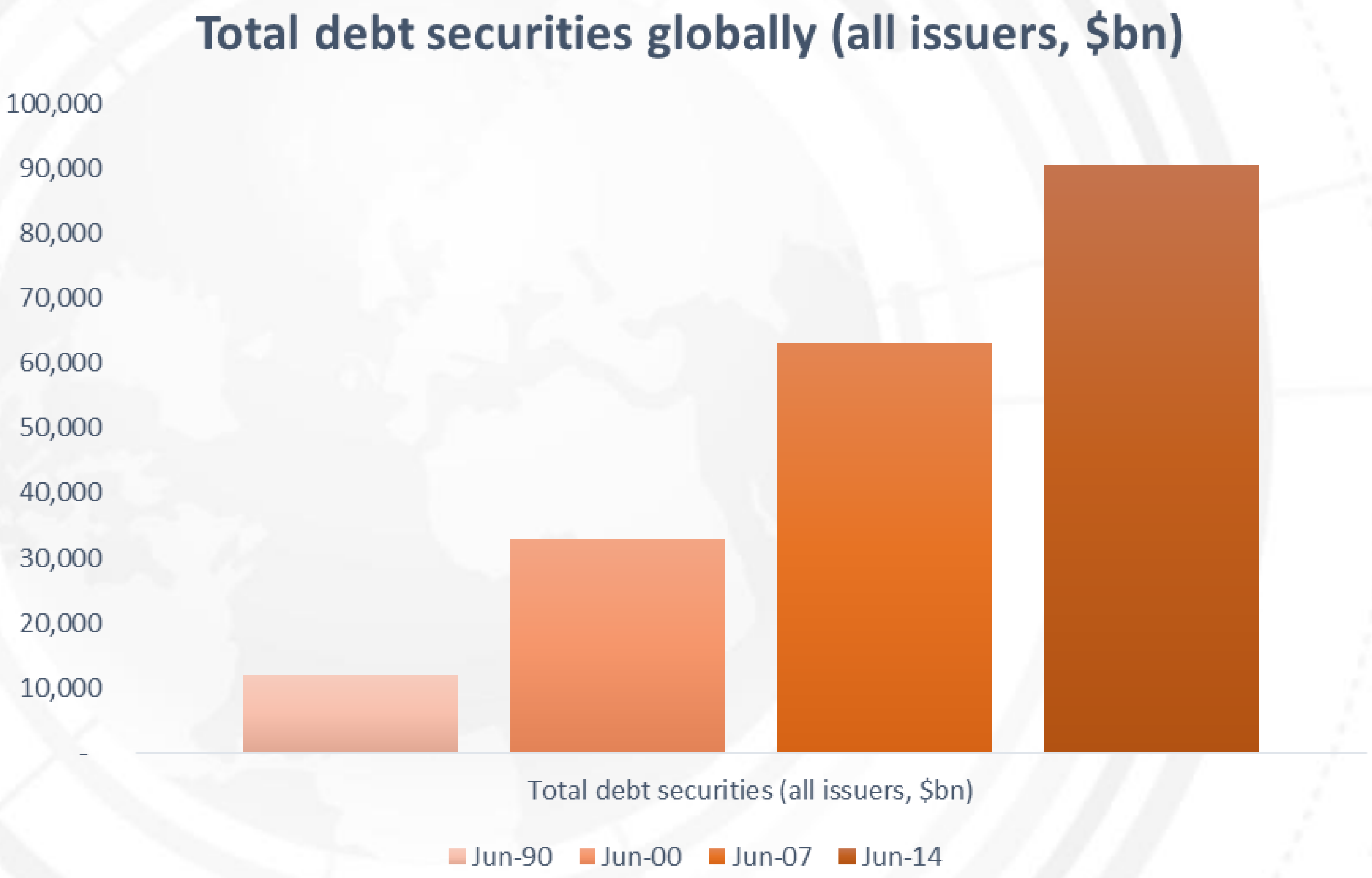
The Cycle of Globalisation and Deglobalisation



Source: BIS, Camdor Global

Copyright © 2016 Camdor Global All rights reserved.

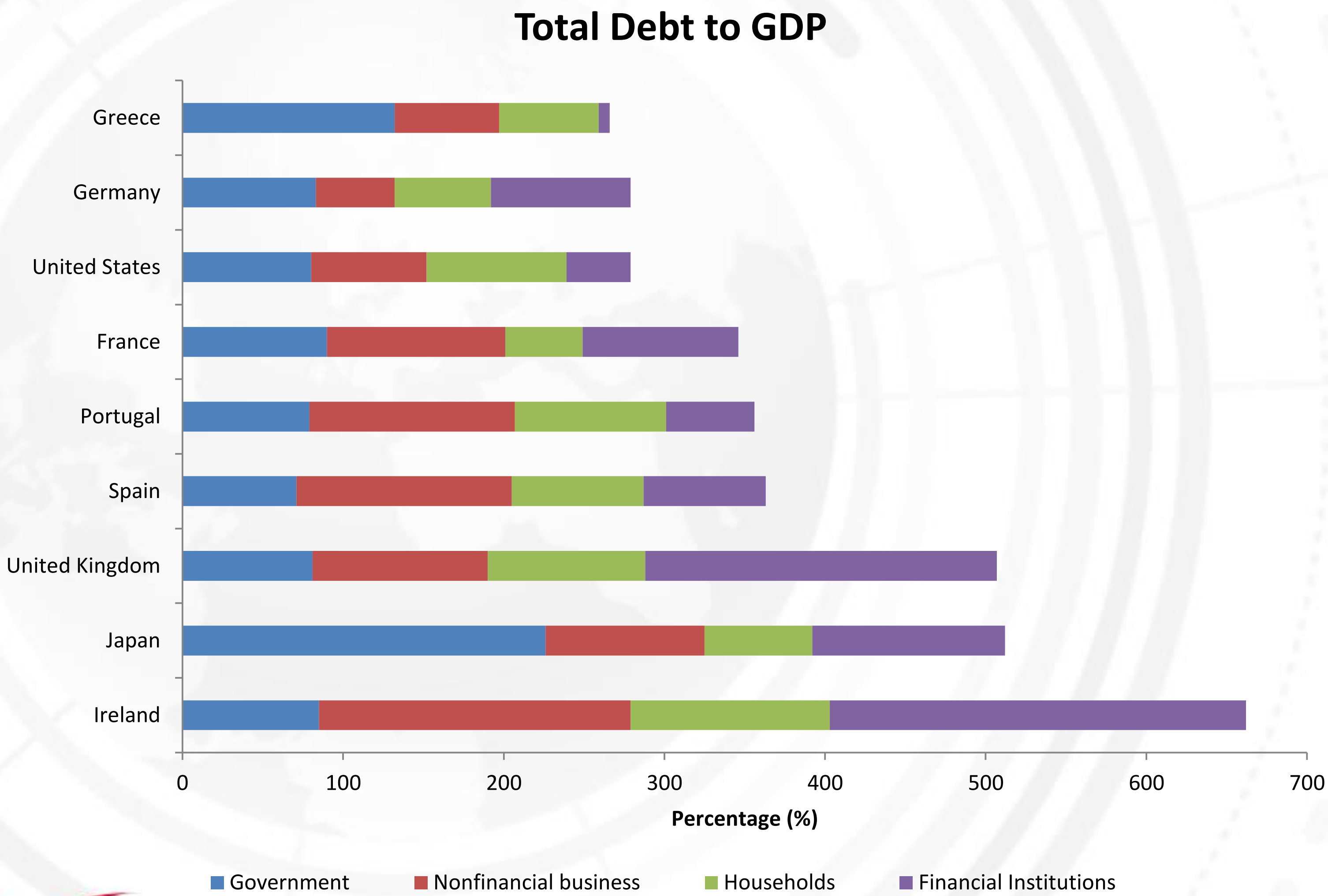
Globalisation grows debt markets



Source: BIS, Camdor Global

Copyright © 2016 Camdor Global All rights reserved.

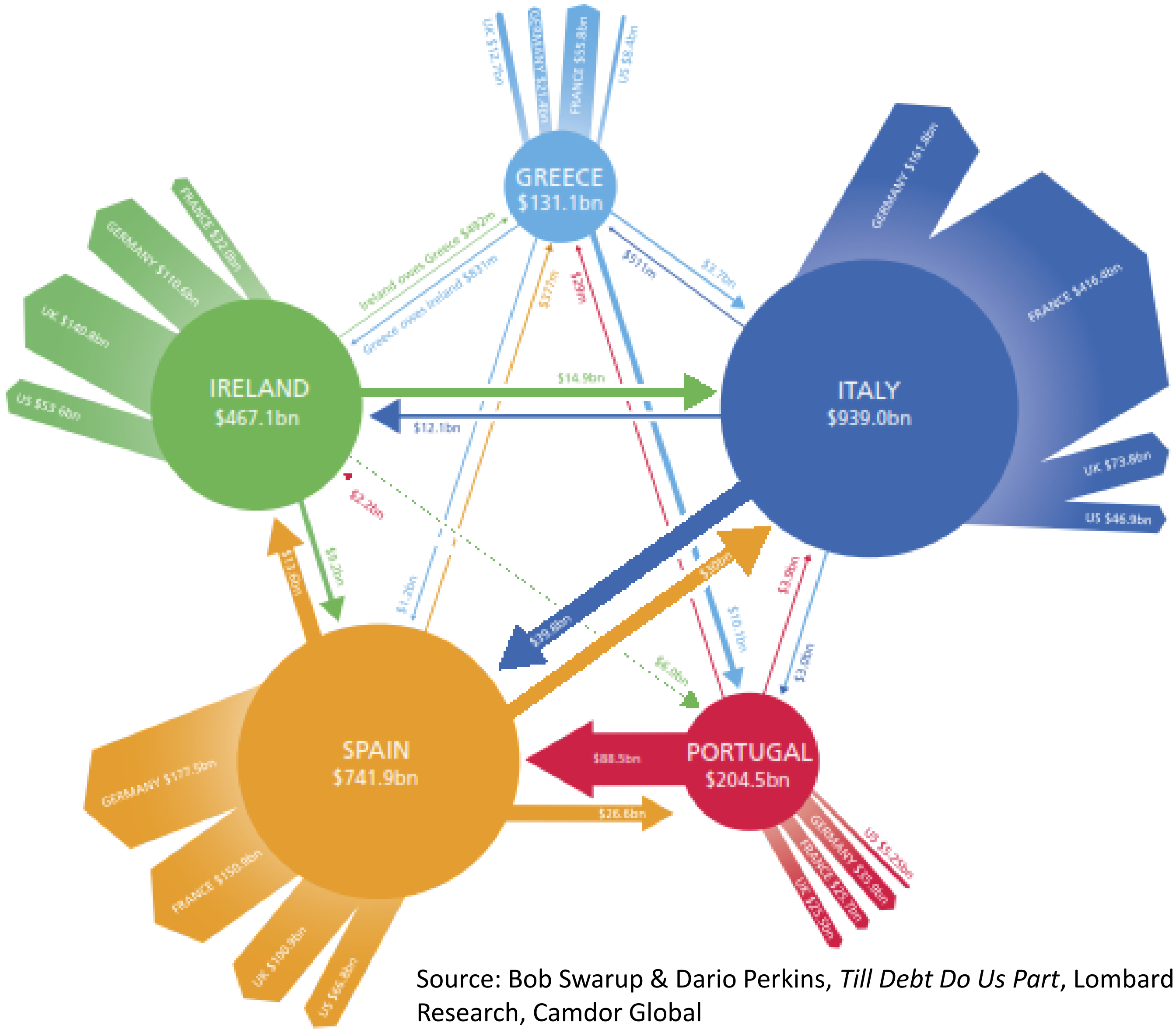
Which become pervasive over time



Source: McKinsey Global Institute

Copyright © 2016 Camdor Global All rights reserved.

…and create complex ties that are hard to unravel



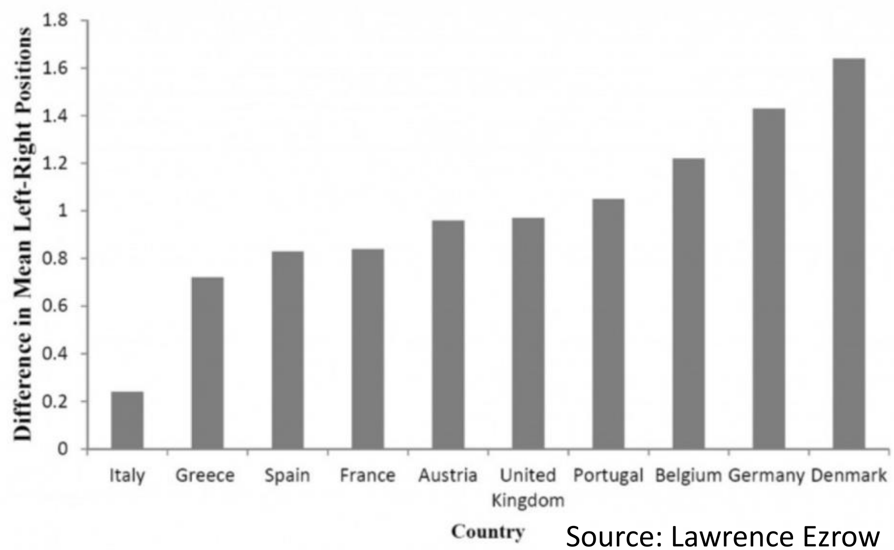
Source: Bob Swarup & Dario Perkins, *Till Debt Do Us Part*, Lombard Street Research, Camdor Global

Copyright © 2016 Camdor Global All rights reserved.

How do politicians lose touch with voters?

- Policymakers respond to:
  - Voters
  - External markets
- The two are not always in unison
- Elections motivate them to respond to voters
- Economic interdependence motivates them to respond to markets

Figure 1. Ideological Bias between Economic Elites and Mass Publics, 2007



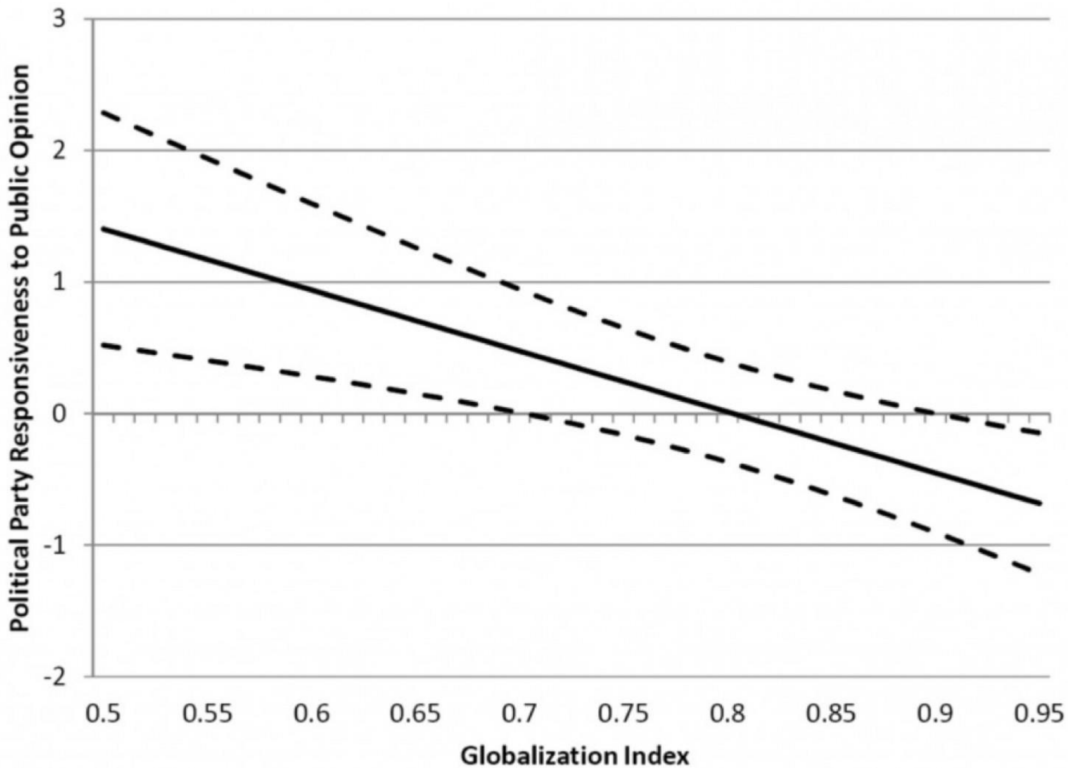
Source: Lawrence Ezrow

Copyright © 2016 Camdor Global All rights reserved.

Globalisation creates disconnects

- Policymakers become less sensitive to their public and focused to their detriment on markets and external players
- True also of urban 'elites'

Figure 2. Effect of Economic Globalization on Political Party Responsiveness to Public Opinion

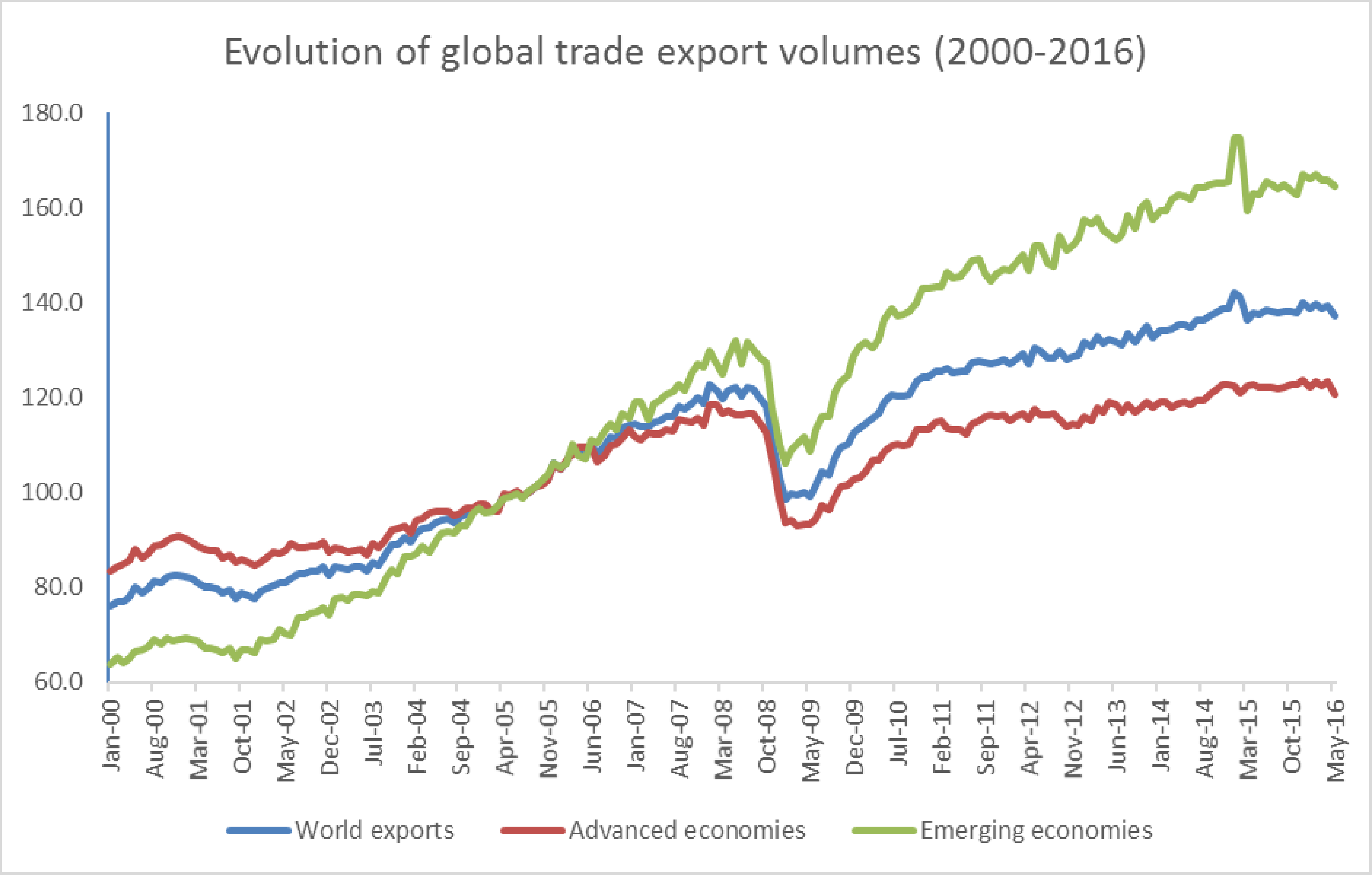


Source: Timothy Hellwig

Copyright © 2016 Camdor Global All rights reserved.

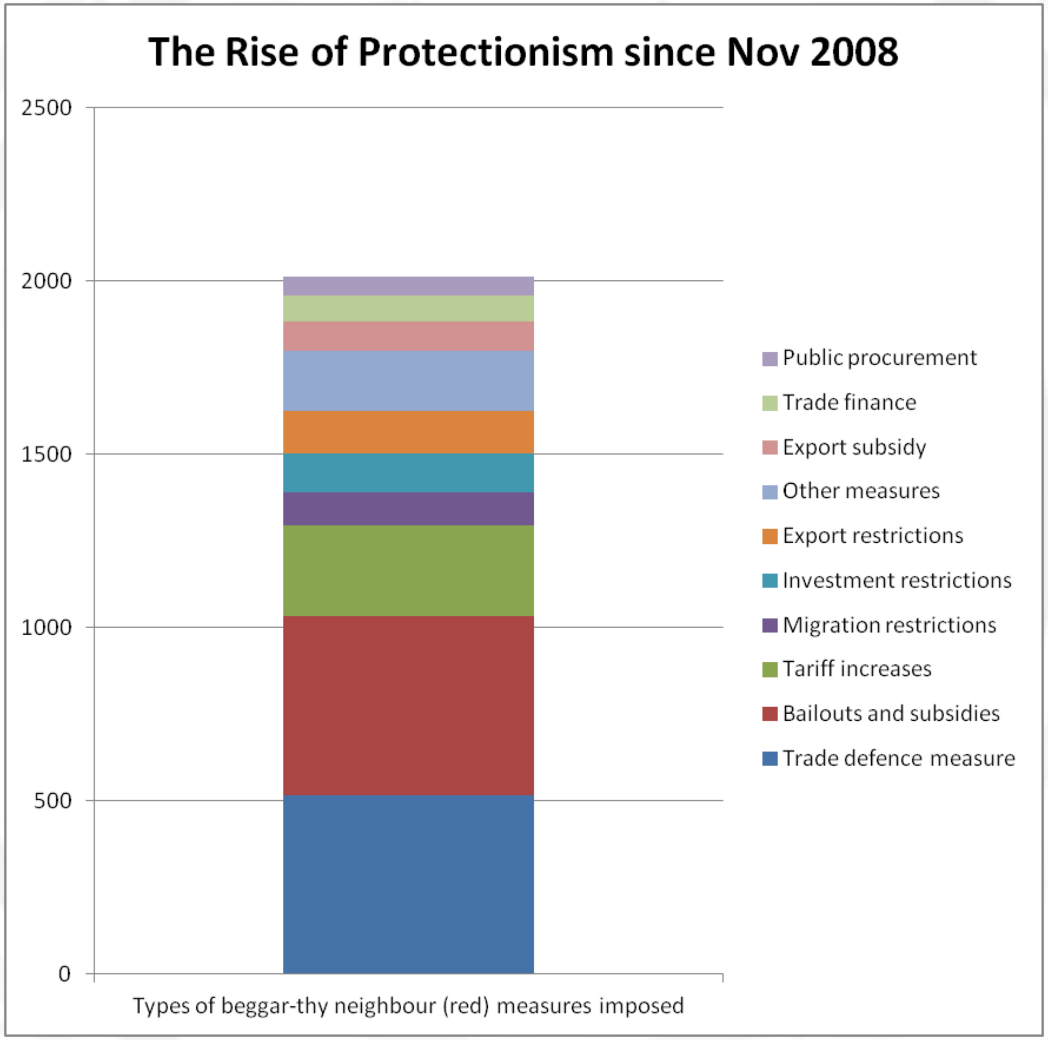
Today we are in Deglobalisation 2.0

- The fractures of globalisation and the rush to economic nationalism



Copyright © 2016 Camdor Global All rights reserved.

The consequences of fear



Source: Global Trade Alert, Camdor Global

- 50% increase between 2014 and 2015
- 80% of protectionist measures from G20 countries

Copyright © 2016 Camdor Global All rights reserved.

The bubble in acronyms

Basel III

Capital requirement: scheduled to increase until 2019
Leverage constraint (LR): 3%
Liquidity coverage ratio (LCR)
Net stable funding ratio (NSFR)

Dodd-Frank Act Title VII

Trade Reporting: completed
Mandatory execution: completed
Mandatory clearing: completed
Margining requirements non-cleared: phasing in since Sep-2016

Brexit

EEA, EFTA, WTO market access?
Equivalence of capital models?

PRIIPs, CSDR, MAD / MAR, MCD, GDPR

Business conduct, custody and depository arrangements,
market abuse, mortgage selling conduct,
cyber security and data protection

CRR / CRD IV [/ CRD V]

OTC Derivatives capital costs: **Completed**

Solvency II

Pillar 1: Valuation and risk-based capital requirements
Pillar 2: Governance and risk management requirements,
Pillar 3: Supervisory reporting and public disclosure.

EMIR

Trade Reporting: completed since 2013 (but not matching well)
Mandatory clearing: phasing in since April 2016
Margining requirements non-cleared: phase in Dec 2016-2019

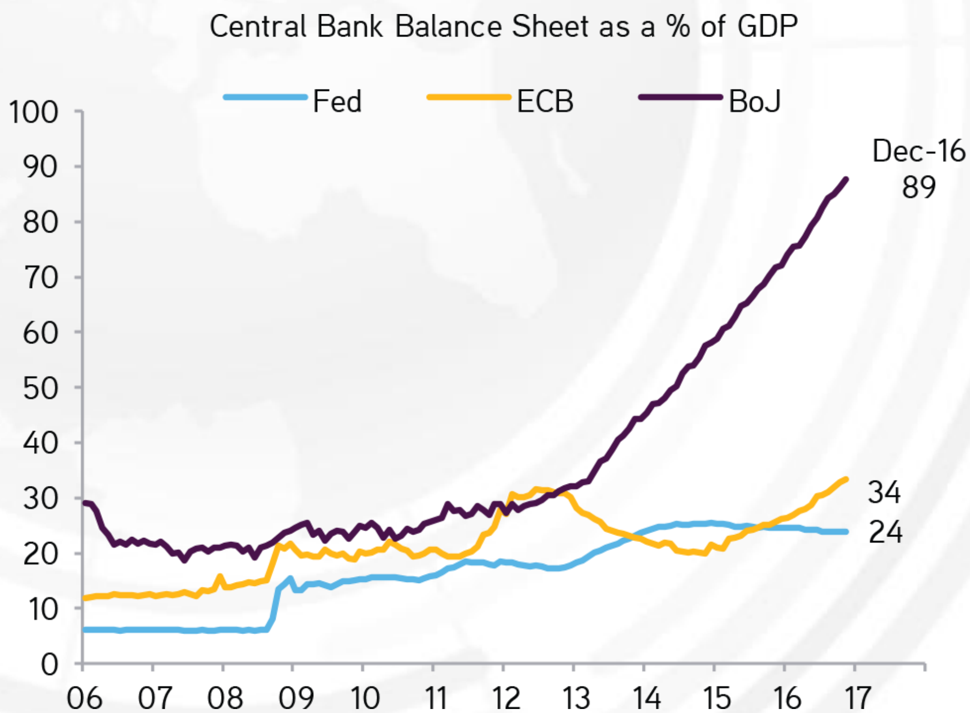
MiFID II / MiFIR

Market structure, execution venues,
trade and transaction reporting,
best execution,
algorithmic trading: anticipated January 2018

Copyright © 2016 Camdor Global All rights reserved.

The problem with just monetary policy

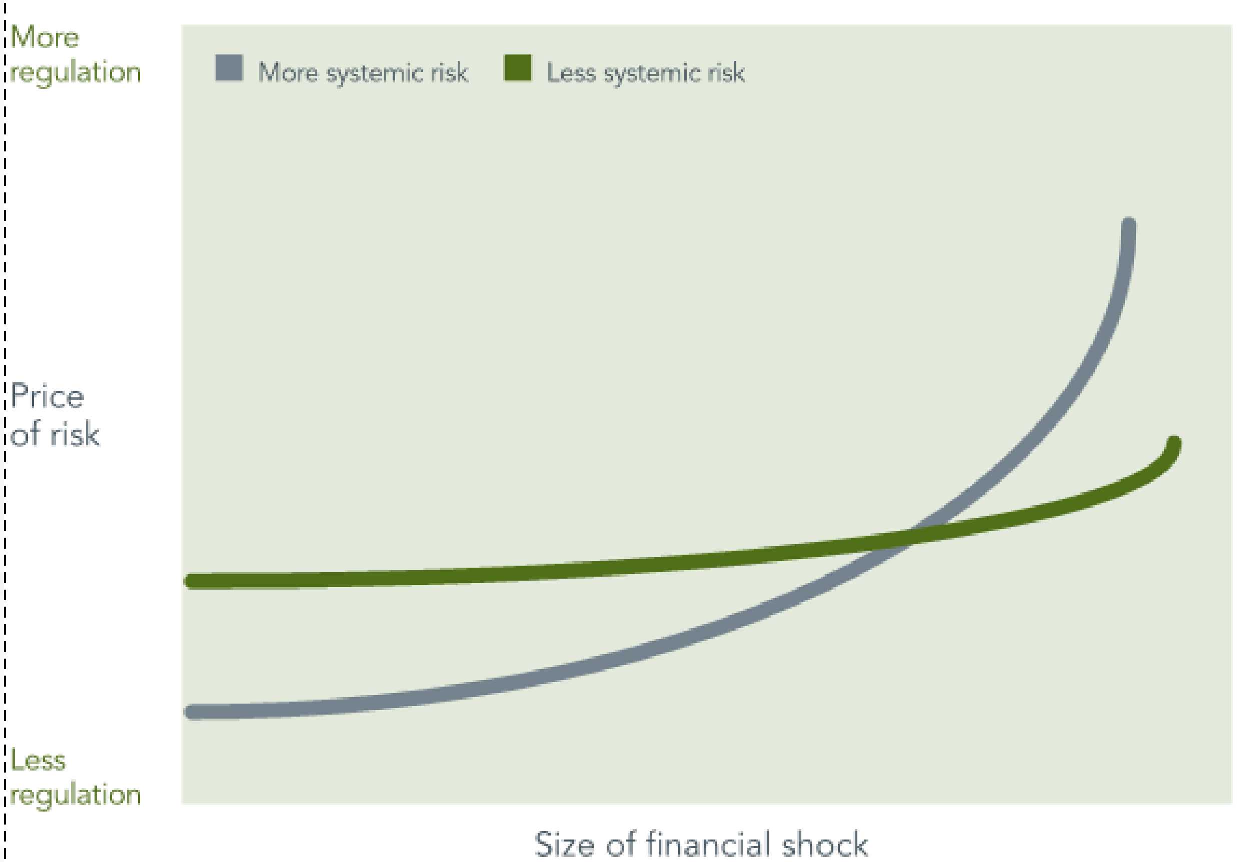
- Central banks are running out of options and reaching for ever more exotic solutions
- Japan on the cusp of direct monetisation
- Monetary easing transmuting to fiscal easing
- Policymakers will in the bulk be driven by domestic priorities



Copyright © 2016 Camdor Global All rights reserved.

Balancing growth and financial stability?

Figure 1: The Trade-off Between Financial Stability and Growth[1]



[1] Source: Camdor Global, based on T. Adrian, D. Covitz and N. Liang, Financial Stability Monitoring, Federal Reserve Finance and Economics Discussion Series (2013)

Copyright © 2016 Camdor Global All rights reserved.

The implications are important

- You cannot divorce economics from politics or society
- Left untended, a crisis of finance will always becomes one of society
- E.g. The Arab Spring, the French Revolution, etc.
- In other words, macro matters

Copyright © 2016 Camdor Global All rights reserved.

Going forward…

- Deglobalisation is set to continue, accompanied by further deleveraging pressures
- Inflationary expectations set to rise as fiscal stimulus becomes accepted
- Domestic priorities dominate over international coordination
- Populism and geopolitics are growing drivers of economic outcomes and eventually markets
- Returns are likely to be weaker, and at risk from protectionist sentiment
- Real returns are likely to persist in negative territory

Copyright © 2016 Camdor Global All rights reserved.

Investor psychology is changing

- Increasing focus on uncertainty of outcomes means greater sensitivity to policymakers
- Money is much harder to make going forward
- Investors are becoming more risk averse...
- …yet also desperate for yield and return in a low-growth world
- A likely generational change for investors over the next 10-20 years

Copyright © 2016 Camdor Global All rights reserved.

The ALM framework needs to be rethought

Risk

- Tail risks
- Short term & long term risks
- Counterparty risks in non-financial market transactions (e.g. buyouts, swaps)

Funding solutions, risk transfers, new structures, bespoke models etc.

Macro trends, new asset classes, origination of direct deals, investment & risk frameworks, etc.

Covenant

- Idealised strategies may be covenant intensive
- Linking the investment strategy and risk transfer solutions to contributions at risk is the key

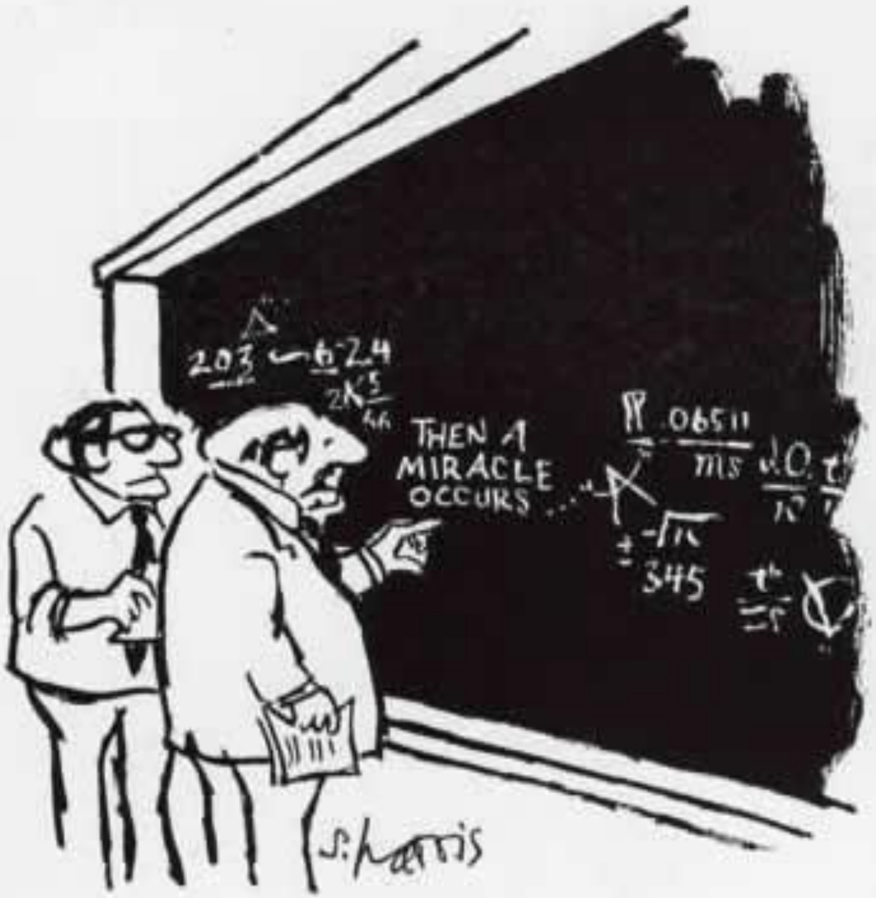
Investor appetite, portfolio goals, governance etc.

Return

- Long term expected returns
- Short and medium term horizons

Copyright © 2016 Camdor Global All rights reserved.

BUT hope is not a strategy



"I think you should be more explicit here in step two."

Copyright © 2016 Camdor Global All rights reserved.

Banking is devolving

- How do you make money in a world of negative rates and increased regulation?
- Banks are retreating from periphery to core
- Bank balance sheets are deleveraging
- Small business lending is anaemic
- Policymakers increasingly looking to pension funds and insurers as providers of alternative debt and growth capital, e.g. SME lending, infrastructure, social housing etc.

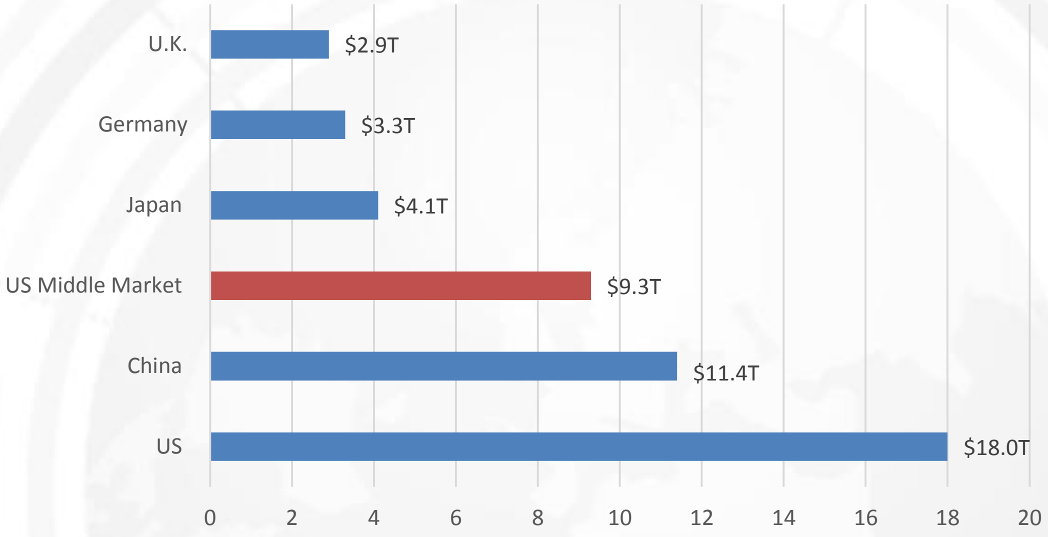
Copyright © 2016 Camdor Global All rights reserved.

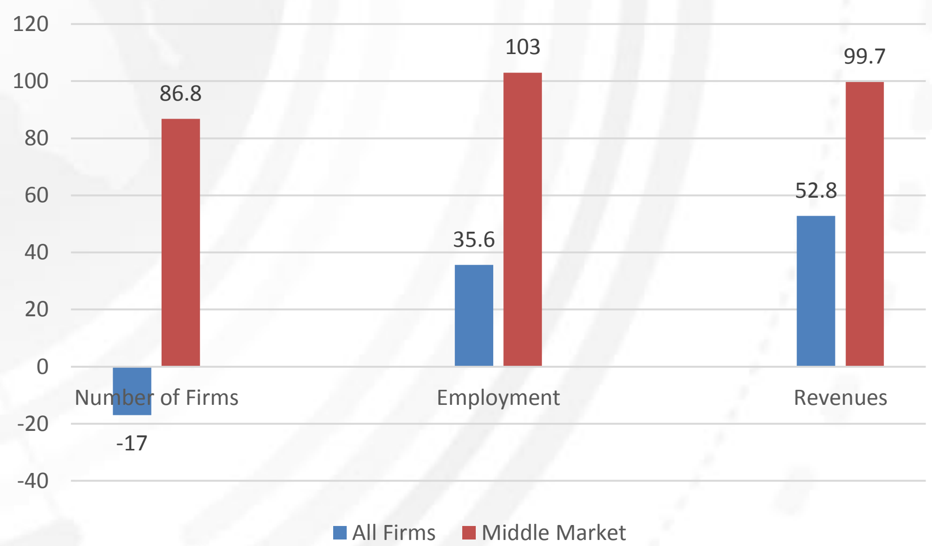
The paradigm is shifting

- Core themes are deleveraging and disintermediation
- Growing emphasis on
  - Genuine diversification
  - Dynamically managing risks
  - Exploiting dislocations
  - Protecting against the downside
- But against that we need to balance
  - The impact of deglobalisation and economic nationalism
  - High valuations, growing risks, less liquidity and more constraints for the majority of investors
  - Returns are harder all round, and nominal returns likely muted for most asset classes going forward
  - Dislocations promise higher returns but may also be swamped by the wall of money looking for returns in a low growth environment
  - And how does the deleveraging occur?

Copyright © 2016 Camdor Global All rights reserved.

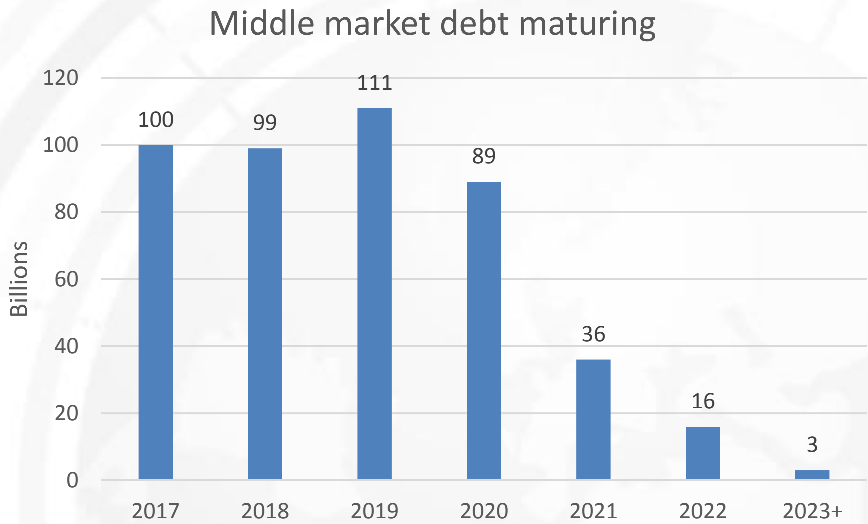
Areas of interest – domestically focused trades

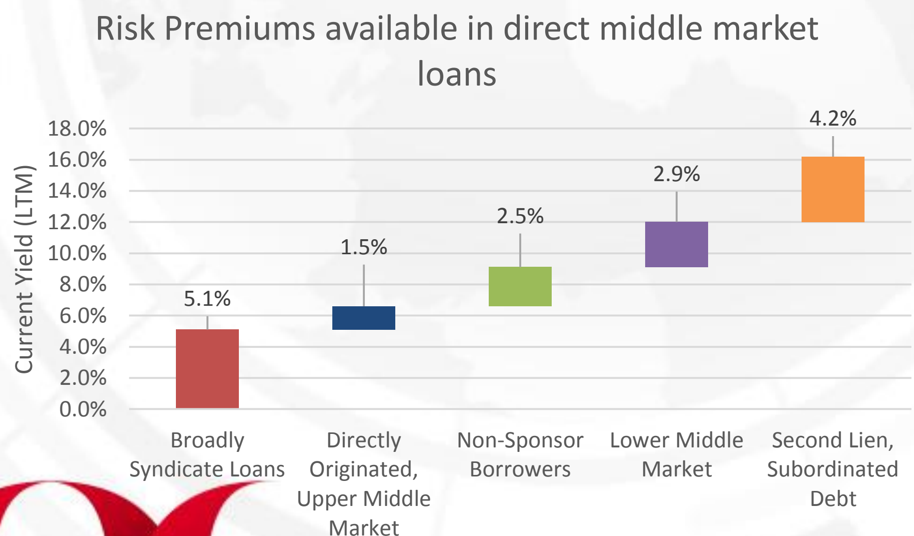




Copyright © 2016 Camdor Global All rights reserved.

Areas of interest – private debt





Industry Average

Product Options	Up-Front Points	Current Cash Yield	PIK, OID Or Other	Equity or Warrants	Expected Return
Levered Bank Loan	0%	3-7%	NA	NA	3-7%
Senior Secured Self-Originated	0-3%	8-12%	0-5%	NA	12-17%
Secondary Loans (1st or 2nd Lien)	NA	7-10%	0-5%	NA	9-15%
Unitranche	0-2%	6-10%	0-2%	NA	7-10%
Mezzanine Loans with Warrants	0-2%	10-12%	NA	0-5%	7-11%
Asset-Based Lending	0-1.25%	3-8%	2-4%	NA	5-12%
Venture Lending	0-3%	10-12%	NA	0-5%	7-12%

Copyright © 2016 Camdor Global All rights reserved.

Other areas?

- Areas we like
  - Real assets
  - Energy and infrastructure
  - Direct transactions
  - Complex value debt and equity transactions
  - Idiosyncrasy over sectoral trades
  - Distressed investing
  - Building up cash reserves
- Areas we are less keen on
  - Public credit
  - High yield
  - Broad equity indices
  - Large-cap private equity
  - Hedge funds

Copyright © 2016 Camdor Global All rights reserved.

Tomorrow?

- What is alpha in a low yield, negative real return world?
- The lines are increasingly blurred today between traditional and alternative assets
- Volatility is set to rise further as countries and economies diverge
- Risk management is set to become more complex
- The importance of reinvention and rethinking
- The critical importance of careful analysis and proactive risk management

Copyright © 2016 Camdor Global All rights reserved.

APPENDIX

Copyright © 2016 Camdor Global All rights reserved.

ABOUT CAMDOR GLOBAL

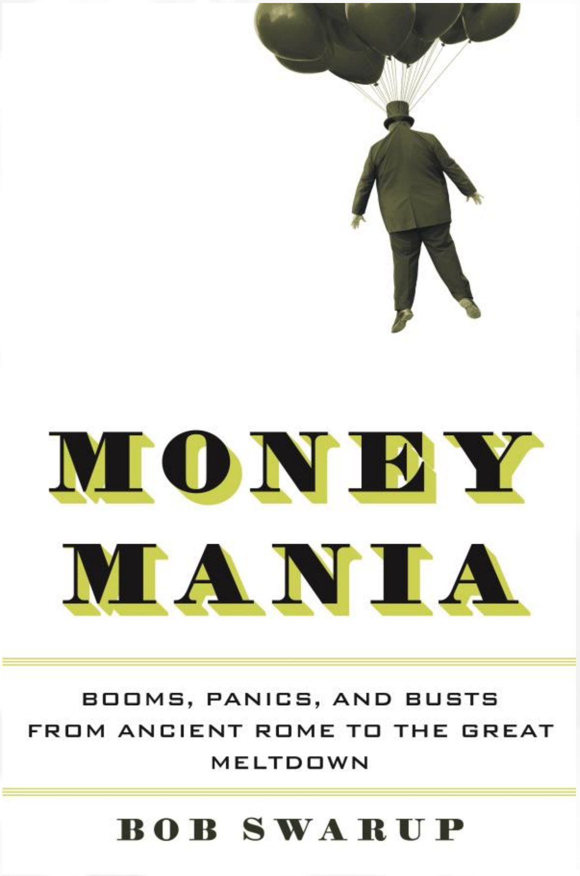
Camdor Global provides leading investors, financial institutions and policymakers around the world with impartial strategic advice and quality independent research on the macroeconomic environment, investment strategy, risk management, governance and regulation. Alternative investments are a particular area of specialisation.

Our guiding principle is that the world is a complex place but our brains are only three pounds. We take the big picture and use our proprietary lenses to reduce today's excess of information down to simple, clear and holistic advice across our core offerings:

- **Macroeconomic advisory:** Independent research and market intelligence that plugs the gap between global macro dynamics and investment, risk and business decisions.
- **Investment and risk implementation advisory:** Bespoke advice around implementation of investment strategy, alternatives, direct investments, integrated risk management and structuring.
- **Governance advisory:** Provision of credible independent members of risk and investment committees that bring specialist investment and risk expertise, as well as valuable added perspectives.

Copyright © 2016 Camdor Global All rights reserved.

ABOUT MONEY MANIA



Twenty-five centuries of financial bubbles, investment manias and human folly explained, with rich historical detail and an insider's financial acumen

"Unusually well-told, and expansive in scope. Similarities between different episodes are breath-taking... His framework provides interesting pointers." ***- Financial Times***

"[An] excellent new book, which looks at booms, panics and busts down the ages. ... Swarup's book comes out at an opportune moment." ***- The Guardian***

"[An] erudite history of financial speculation." ***– The Economist***

"[A] rigorously researched history packed with great stories and insights. Swarup takes the reader through a fascinating and thought provoking analysis of emotional biases, money, credit and social complexity.... The vexing question for every serious investor today is whether our uniquely complex modern society is at risk of another systemic crisis. Money Mania is a timely, well written reminder that this question should be given renewed priority." – ***Paul Tudor Jones, Tudor Investment Corporation***

Copyright © 2016 Camdor Global All rights reserved.

PRINCIPAL BIO

Dr Bob Swarup is a respected international expert on financial markets, investment strategy, alternatives, ALM and regulation. He is the founder of Camdor Global, an advisory firm that works with institutions and investors around the world on strategic investment, risk management, ALM and regulatory issues. He is also the co-founder of the Insurance Investment Exchange, the leading forum for insurers globally to debate investment issues.

Bob was formerly a partner at Pension Corporation, a leading UK-based pension buyout firm with $20bn in assets, where he oversaw alternative investments, was Chief Risk Officer and ran the thought leadership unit. Bob has also served on the Advisory Board of Adveq, a leading Swiss PE firm; the Board of CatCo, a $2bn reinsurance hedge fund that he helped seed in 2011; and on several committees of the Association of British Insurers.

Bob is a Fellow of the Institute of Economic Affairs; a Senior Visiting Fellow at Cass Business School; and on the Advisory Council of the Columbia Committee for Global Thought. He holds a PhD in cosmology from Imperial College London and an MA (Hons) from the University of Cambridge. Bob has written extensively on diverse topics, with his work appearing in the Financial Times, Economist, Guardian, CNBC, Bloomberg, Boston Globe and others. His latest book is the internationally acclaimed bestseller *Money Mania,* examining over two millennia of financial crises and the lessons for us to learn (Bloomsbury, 2014).

Copyright © 2016 Camdor Global All rights reserved.

CONTACT

T: +44 (0)7801 552755
E: swarup@camdorglobal.com

Copyright © 2016 Camdor Global All rights reserved.