Market Commentary: on QE, Liquidity, and Returns

"As the risks arising from leverage and liquidity mismatches in investment funds are potentially systemic, we need to take a more ambitious policy approach to systemic risk"

Luis de Guindos, Vice-President of the ECB, 12 November 2018

The return of QE

Recent developments in Europe have pointed to the return of "ECB signature markets". Mario Draghi's comments on 18 June were indeed a powerful reminder of the invisible hand of the ECB on markets, characterised essentially by two key points:

- First, negative interest rates and yields. The 5-year Bunds are currently yielding -0.625%, their lowest level ever;
- Second, potential for further QE. Mr Draghi was quite forceful as regards the ECB's potential to re-boost its bond-buying programme should inflation fail to improve.

Let's face it, not many will beat Long Only funds and ETFs at this game. The week of Mario Draghi's speech epitomised the pattern. The best symbol of this "Risk On" revived new world, the S&P 500 hit a new all-time high, up 94% since the highs from 2007 (and up 270% since the 2009 lows).

The Return of the Liquidity Mismatch

On that very same week, an article published in the Financial Times attracted attention to a large daily liquidity asset manager (H2O), highlighting the fact that a portion of its assets was invested in very illiquid bonds, whose valuation methodology was in question, and all sourced via a colourful businessman[1]. The consequences were brutal, with over €5bn in redemptions triggered within the next few days, and Natixis, which owns 49.99% of the asset manager, dropping over 13% within a couple of days, costing them over €1.5bn of market capitalisation.

The stigmatisation of H2O comes after the gating of GAM last year and more recently, Neil Woodford's flagship fund. They all highlight a liquidity mismatch where the highly sought after "daily liquidity funds" have succumbed to the (legal) temptation of loading their funds with instruments whose liquidity is probably far from daily.

[1] "H2O Asset Management: illiquid love". Robert Smith and Cynthia O'Murchu. 18 June 2019

Correlation or Causation?

Is the collusion of those two very distant stories in the same week a random event? Or is it the reflection of the growing imbalances in the market? We see no coincidence here, rather a causal relationship.

The combination of (i) strict liquidity requirements by investors (leading notably to the rise of UCITS funds in Europe), and (ii) the necessary hunt for returns in a negative yield environment, have created a very powerful time bomb.

This thesis is not new. We discussed it over a year ago in an investor letter[2], however the first cracks in the market proved benign. The highly publicised gating decisions that have taken place since then (GAM ARBF, Woodford Equity Income Fund) have not led to any widespread panic. The market also remarkably withstood the market volatility and sell-off in Q4 2018 (clearly beyond our expectations), coming back full steam in the first half of 2019.

We see two reasons to give renewed attention to this thesis.

Firstly, public focus has shifted to the liquidity mismatch, with a hunt for those alleged villains who held an illiquid pocket in their fund - even though fully disclosed and legal. So far, scrutiny is triggered either by poor performance (in the case of Neil Woodford) or alleged poor practice in the selection of these illiquid buckets (GAM and H2O). Pressure will now be mounting on all those illiquid buckets which often contributed significantly to the performance of the funds. The topic starts to be in fashion.

Secondly, our conviction is that whilst intense scrutiny is mounting on illiquid buckets, there might well be a misunderstanding at play here. Forget the 10% illiquid buckets for a moment. The more profound risk, the "Big One", is about those new asset classes where ETFs and specialist funds have blossomed in the past years. The liquidity on these asset classes will only last until the music stops. The CoCos market, which froze totally in January and February 2016 and had exponential growth since 2014, comes naturally to mind.

Will the music ever stop?

Uncertainties are clearly looming, be it on European growth, tariffs, Brexit, etc. Does this matter ultimately? With the new QE push from Mario Draghi, it makes real sense to consider going long for a new round and enjoy the ride.

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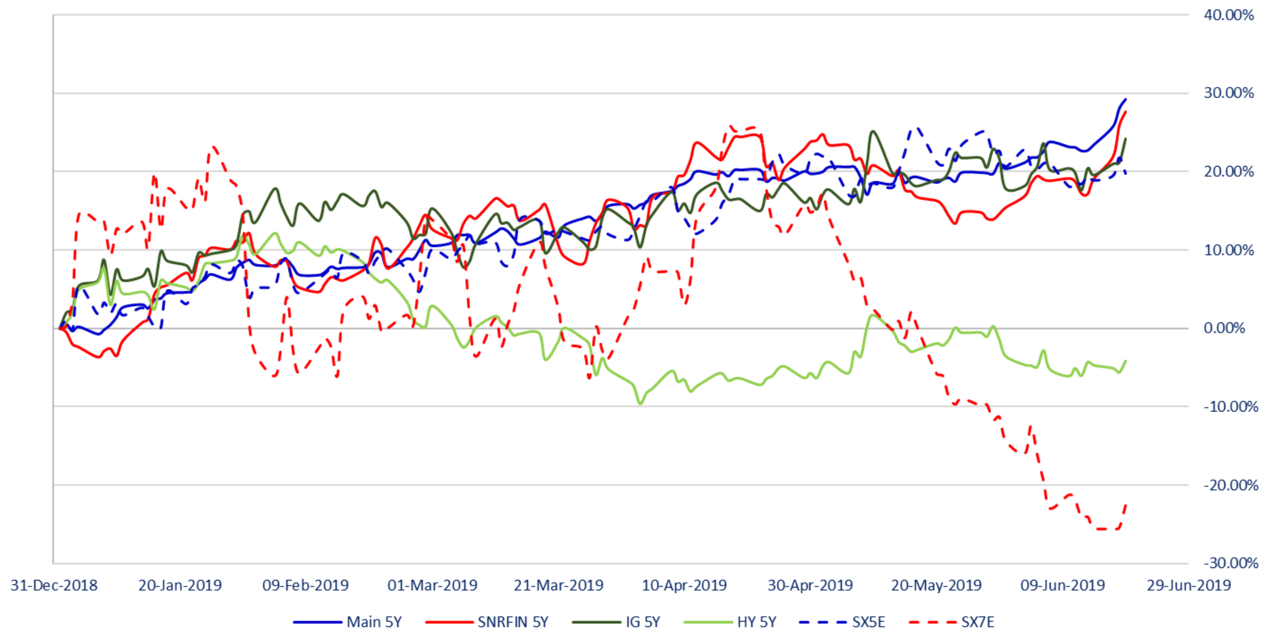
[2] https://www.chenavari.com/assets/Uploads/4d521baf1d/Lyxor-Chenavari-Credit-Fund-UCITS.pdf
In a nutshell, our thesis was that some large drawdown episode (potentially facilitated by the end of QE) would trigger redemptions from daily liquidity funds, which would not be able to cope properly given their liquidity mismatch, thereby creating valuation discontinuity, and generating in turn more redemptions. A vicious circle offering bargain opportunities for those capable of investing against the tide.

This is fair enough. There is only one thing – when does the ride stop? We do not feel better equipped than any other market participant to answer this question, but we are very intrigued by the recent movements of European Bank equities (Index: SX7E), which have come at odds with the market bonanza.

Chart 1: Beta-adjusted percentage move, relative to XO 5Y, normalised



Source: Bloomberg and Chenavari estimates as at 18 June 2019

The question is, what is the market trying to tell us here?

One classic narrative is that Europe is en route to "Japanification". In such a context, bank equities are precisely the asset class to avoid as their profitability relies primarily on rates levels and loan demand, both of which are looking doomed for an extensive period. However, Japanification is a simplified comparison given the openness of the European economy, the efforts from Central Banks to tackle issues, and the magnitude of disruption / transformation triggered by technology in today's economies. Also, the magnitude and brutality of the trend does not match with the lingering theme of Japanification.

Another interesting narrative could be that the SX7E has become an advanced indicator of the forward default risk. In a nutshell, the price of bank stocks relies on:

- Rates, which admittedly can't go much further down from where they already stand;
- Leverage and equity levels, which are quite constrained by regulatory requirements; and
- The cost of risk, most notably losses driven by the default rate.

In this light, the market is saying that something will soon have to give – and that something can only be the cost of risk. Under this scenario, the message would then be, brace yourself for an increase of defaults in the corporate world.

This is quite consistent with the "QE fuelled" credit cycle, where investors have dabbled into riskier territories in their search for yield and into looser covenants. If this were to be true, then the moment when the music stops might be a little sooner than one expects. In this context, our conviction is that one should reallocate out of ETFs and "big" long only funds into diversified funds with a nimble long short approach and a reasonable size.

UCITS strategy positioning: enjoy while it lasts, protect when it cracks

This scenario cannot be ruled out and is clearly on our minds as we monitor the liquidity profile and net exposure of our UCITS strategy. Our aim is to monetise part of the upside of the risk-on, QE-led market environment, and yet ensure that we are protecting the performance should market conditions turn. We therefore manage a diversified portfolio supported by fundamentals, with special attention to liquidity of the underlying instruments. Our risk team have set up their own liquidity rating model, which enables them to track and challenge the liquidity of the holdings.

For those with an even more directional conviction or looking to hedge, Chenavari has implemented trading strategies in an offshore vehicle taking a short bias on the European credit market to manage tail scenario.

Conclusion: "Good cheap fast" applied to today's markets

The famous adage on the impossible trinity in the Corporate world goes like this:

"*We offer 3 kinds of services – GOOD, CHEAP, FAST. But you can pick only two.*

Good and cheap won't be fast,

Fast and good won't be cheap,

Cheap and fast won't be good."

In the current market environment, this can be translated as follows:

"*Liquid and juicy won't be robust,*

Liquid and robust won't be juicy,

Robust and juicy won't be liquid."

Think about it when allocating. If you feel the investment on the table meets the trinity criteria, then you may have found the holy grail - or not.

With our best regards,

Vincent Laurencin

Deputy CEO

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CEO, co-CIO

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Should you wish to arrange a follow-up discussion, please do not hesitate to contact us:

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All data sourced from Bloomberg unless otherwise stated.

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