EXECUTIVE SUMMARY

- We recognize that periods of heightened volatility can be difficult for investors, and we very much appreciate the trust that our clients place in us.

- The underlying causes of recent market volatility appear driven by market reactions to conditions in China, particularly the depreciation of the yuan, the decline of the stock market and broader economic concerns. However, underlying conditions in the Chinese economy appear fundamentally more stable than the markets have been indicating, in our view.

- Despite near-term volatility, our medium-term convictions remain intact. We have continuously evaluated our positions and continue to conclude that our strategies are fundamentally positioned the way we would like them to be positioned for the several-year period going forward.

- Heightened levels of broad-based volatility can be unsettling but also can provide significant opportunities for investment, particularly for a strategy that seeks to take advantage of near-term pricing dislocations for longer-term investment.

- In our assessment, several emerging-market (EM) currency depreciations in recent months have been excessive, leading to fundamentally cheap valuations. We selectively add to our strongest convictions in periods of volatility and believe that global market fundamentals will eventually re-emerge.

- Our negative positions in the euro and the yen are intended to serve as proxy hedges for broad-based strengthening of the US dollar. We are expecting differentiation across global currencies over the medium term with a continued depreciation of the euro and yen.

- We continue to believe the US Federal Reserve will need to raise rates later this year. We have identified specific EMs that we believe are in a better position to raise rates in conjunction with the US and/or perform relatively better than their peers over the medium term.

We Appreciate Our Clients’ Trust and Remain Confident in Our Fundamental Positioning Despite Ongoing Market Volatility

We recognize that periods of heightened volatility can be difficult for investors, and we very much appreciate the trust that our clients place in us. We wish to assure our clients that we continue to evaluate our portfolio holdings throughout these periods of volatility and that we continue to perform our due diligence in an ongoing and constant manner. In reviewing our strategies, our fundamental assessments of our strongest investment convictions have not changed, despite the challenging near-term shifts in valuations. In our view, longer-term fundamentals will eventually re-emerge in valuations after market dislocations and excessive risk aversion have dissipated. In this context, we continue to remain confident in how our portfolios are positioned for the medium to longer term.

What Is Causing Current Market Volatility and What Should We Expect Going Forward?

The volatility that we’ve seen in recent months, and particularly in recent weeks, is reflective of a broad-based market panic, in our opinion. Such periods of volatility can be unsettling, but they also can provide significant opportunities for investment, particularly for a strategy like ours that seeks to take advantage of near-term pricing dislocations for longer-term investment.
The underlying causes of recent volatility appear driven by market interpretations of conditions in China. The devaluation of the Chinese yuan in mid-August by about 5% appeared to raise fears that it could be a precursor to a deeper depreciation, potentially a massive, uncontrolled devaluation. We also saw major depreciations of neighboring Asian currencies, such as the Malaysian ringgit and Indonesian rupiah.

However, before the depreciation of the yuan, neighboring Asian emerging-market currencies had already significantly depreciated. Concurrently, the yuan remained essentially unchanged in value against the US dollar. In our view, the recent 5% depreciation of the yuan doesn’t necessitate a significant depreciation of Asian currencies to keep them competitive. We believe that the excessive depreciation of several EM currencies is a misread by the markets—several EM currency depreciations are overdone, in our view.

The second issue to consider is that China has been experiencing some capital outflows, and this small depreciation is in line with those trends. We believe Chinese authorities are likely to focus on keeping currency depreciation reasonably controlled. China had already been loosening monetary policy by cutting interest rates and reserve requirements. We believe these types of targeted policies are likely to continue in an effort to cushion the moderation of the economy. However, we don’t believe they should be viewed as signs that the Chinese economy is collapsing, rather they are prudent policy responses to a moderating economy.

Finally, the large corrections in the Chinese stock market that began in late June and that have continued into recent weeks have had an effect on global market sentiments. However, China’s stock markets are not as indicative of the overall conditions of the macro economy as stock markets are in other developed countries. That’s because the Chinese stock market is not widely held—there is only a small fraction of Chinese households that own any stocks. Thus, the usual wealth effect is far less relevant, and far less impactful to consumption.

Although global market volatility in recent weeks has reached a level of broad-based panic, underlying conditions in the Chinese economy appear fundamentally more stable than the markets have been indicating, in our view. The widespread volatility has offered us significant opportunities for longer-term investment, and we believe global market fundamentals will eventually re-emerge.

How Do You Manage Portfolio Risk?
We actively manage risk on an absolute basis, preferring to use measures such as Value at Risk and Expected Shortfalls. Given that our strategies are frequently contrarian, some of our best results have come after periods of significant underperformance. Some types of risk parameters, such as stop-losses, are not appropriate for our strategy because we may need to weather periods of short-term volatility in order for our longer-term investing theses to manifest. For example, some of our best results came after the period of volatility in 2011. If we had been restricted by stop-losses we would not have been able to build the positions that ultimately provided favorable outcomes, notably Ireland and Hungary, which were very much out of favor during that period.

There may continue to be periods of sharp spikes in volatility. We are trying to manage that volatility and to protect against specific risks. We view the most significant risk for fixed income investors as the risk of permanent capital losses as rates normalize. We are still close to historic lows in rates across the globe. We may see intermittent periods of declining yields, but the longer-term trend will be rates incrementally moving higher, in our opinion. We are at the lowest levels of portfolio duration we have ever had to try to protect our clients from the losses in capital that would occur when rates rise.

Will US Rate Hikes Be Postponed?
Markets have been on edge waiting for the US Federal Reserve (Fed) to hike interest rates. We do believe the Fed will need to raise rates later this year. We are medium term in our investment horizon, so the exact timing and exact month of a hike does not matter to us. However, the longer the Fed delays, the greater the macro imbalances build up and the greater the distortions to the economy build up. Currently, the US economy is growing and doing well—its labor markets are strong. Against this background of solid growth, the US continues to have this unusually low level of interest rates and very loose monetary policy. It leads to distortions in financial markets.

We do see periods when rates rally during recent spates of risk aversion. The 10-year US Treasury recently rallied 20–25 basis points (bps), dropping to 2.00% in late August, but those yields did subsequently bounce back up. Our point has been that there is an asymmetry of risks. Rates can rally, but the extent to which they can rally from their current unusually low levels is much smaller than the extent to which they can sell off.
Regarding inflation, we are less sanguine than markets seem to reverse. Higher levels of yield are more long-lasting and less likely to be. The decrease in oil prices had a major effect on driving inflation lower, but that level-setting has already been factored in. We have seen wage pressures develop in specific areas of the labor force along with skills mismatches. Core US inflation is running at around 1.8%. We believe inflation pressures could become more significant than markets appear to be expecting.

As consumption picks up, we would expect inflation to pick up as well. We are coming out of a period when inflation has been very low, so we have become accustomed to low inflation. However, we have seen inflation increase in several emerging markets, and we expect it to pick up globally. Additionally, there is a significantly large overhang of global money supply which will add further inflationary pressure when inflation trends re-emerge.

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Can EM Currencies Perform Well in an Environment of US Rate Increases?

We believe the effect of US interest-rate hikes on EMs will not be universally the same—some EMs are in far better position to raise rates in conjunction with the US and/or perform relatively better than their peers. Some of our strongest conviction investments are fundamentally undervalued in our assessment: for example, the Mexican peso. The recent bout of volatility sent the peso above 17 per US dollar. We haven’t seen these levels since the full-out Tequila Crisis in 1994. However, Mexico is a far different country today; it has a large reserve cushion and benefits from sound fiscal and monetary policies, along with a strong export profile, notably to the US consumer. Markets have looked at Mexico and identified it as an “oil exporter” that is suffering from lower oil prices. But less than 10% of Mexico’s exports are from oil. Fundamentally the currency is much stronger than its current valuation, in our assessment.

Do You Still Intend to Short the Euro and Yen?

The euro and yen reacted as perceived safe havens during the recent spike in volatility from the fall of the Chinese stock market, the devaluation of the yuan and fears of economic collapse in China. However, longer-term fundamental strengthening in the euro and yen is not likely, in our view. Across the G3 (meaning the US, the eurozone and Japan), it’s still the case that the Fed will likely hike interest rates well before the European Central Bank and the Bank of Japan, which have both indicated that they are in no hurry to exit their quantitative easing policies. We have seen a slight reversal of the euro strength and yen strength in recent days, and we think that will continue over upcoming months. Our negative positions in the euro and the yen are intended to serve as proxy hedges for broad-based strengthening of the US dollar.

In recent months, our negative positions in the euro and the yen worked against us, as the currencies strengthened during spates of risk aversion and heightened volatility. Additionally, global currencies broadly sold off, while US Treasuries rallied. We recognize that periods such as these are difficult for our clients. However, our medium-term convictions remain intact. We have continuously evaluated our positions and reinvestigated how we feel about each of the investing theses in our portfolios. We come back to the view that our strategies are fundamentally positioned the way we would like them to be positioned for the several-year period going forward.

**WHAT ARE THE RISKS?**

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size, lesser liquidity and lack of established legal, political, business, and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year. Derivatives, including currency management strategies, involve costs and can create economic leverage in an investment portfolio which may result in significant volatility and cause the portfolio to participate in losses (as well as enable gains) on an amount that exceeds its initial investment. A portfolio may not achieve the anticipated benefits, and may realize losses, when a counterparty fails to perform as promised.
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