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***2020: Volatility And More Mini-Bond Cycles***  
Colleen Denzler, CFA

# 2020 Themes: Smith Capital Investors View of What to Watch

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We anticipate another year of volatility and increased mini-cycles of bond and stock returns

1. Politics
2. Inflation and Inflation Expectations
3. Interest Rates: Another year of volatility and uncertainty
4. Credit: The Have and Have Nots
5. Cost of Capital, Value Creation and Creativity
6. Active Management: The great debate will continue but results will speak for themselves

# Theme 1 – Politics

## *Presidential Elections Can Create Uncertainty in the Markets*

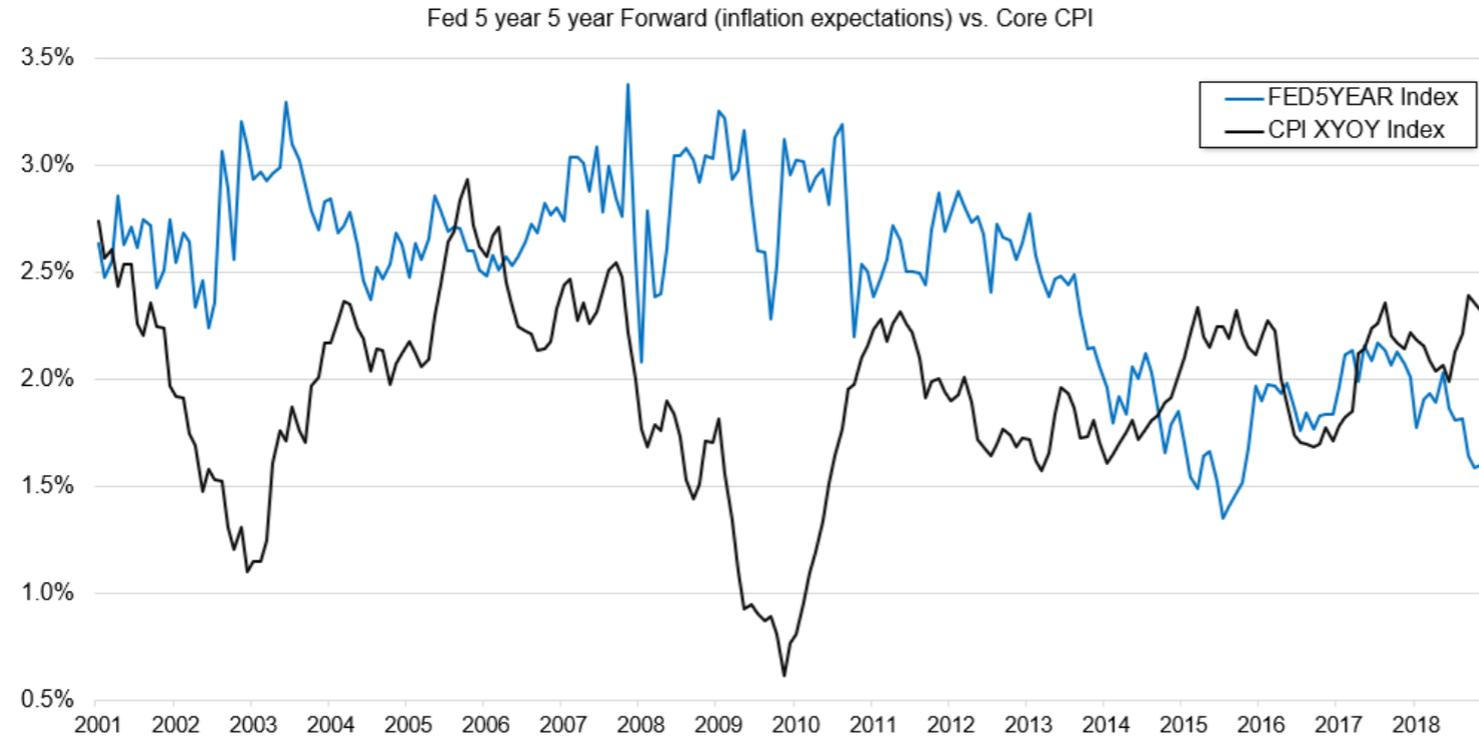
	Potential Outcomes			
	Trump President Split Congress	Trump President Republican Congress	Democratic President Democratic Congress	Democratic President Split Congress
Taxes/Spending	Status Quo	Tax Cuts Part II/Increased Spending	Increased Taxes/Increased Spending	Spending & Taxes Increase on margin
Trade	Continued Uncertainty	Increased Trade War	Trade Issues remain, approach changes	Trade Issues remain, approach changes
Changes	Further attempt to ease regulations, frequent gridlock	Further easing of regulations, Legacy Building 2nd Term	Healthcare, Increased Regulation Banks Pharma & Tech, Gun Restrictions, Climate Change	Less pro-business, increased regulation

Source: Smith Capital Investors

- At this time, markets seem to be predicting a status quo outcome, but uncertainty around that outcome during the year will contribute to mini-cycles in stocks and bonds.

# Theme 2 – Inflation and Inflation Expectations

*Global Central Banks Let it Run...*

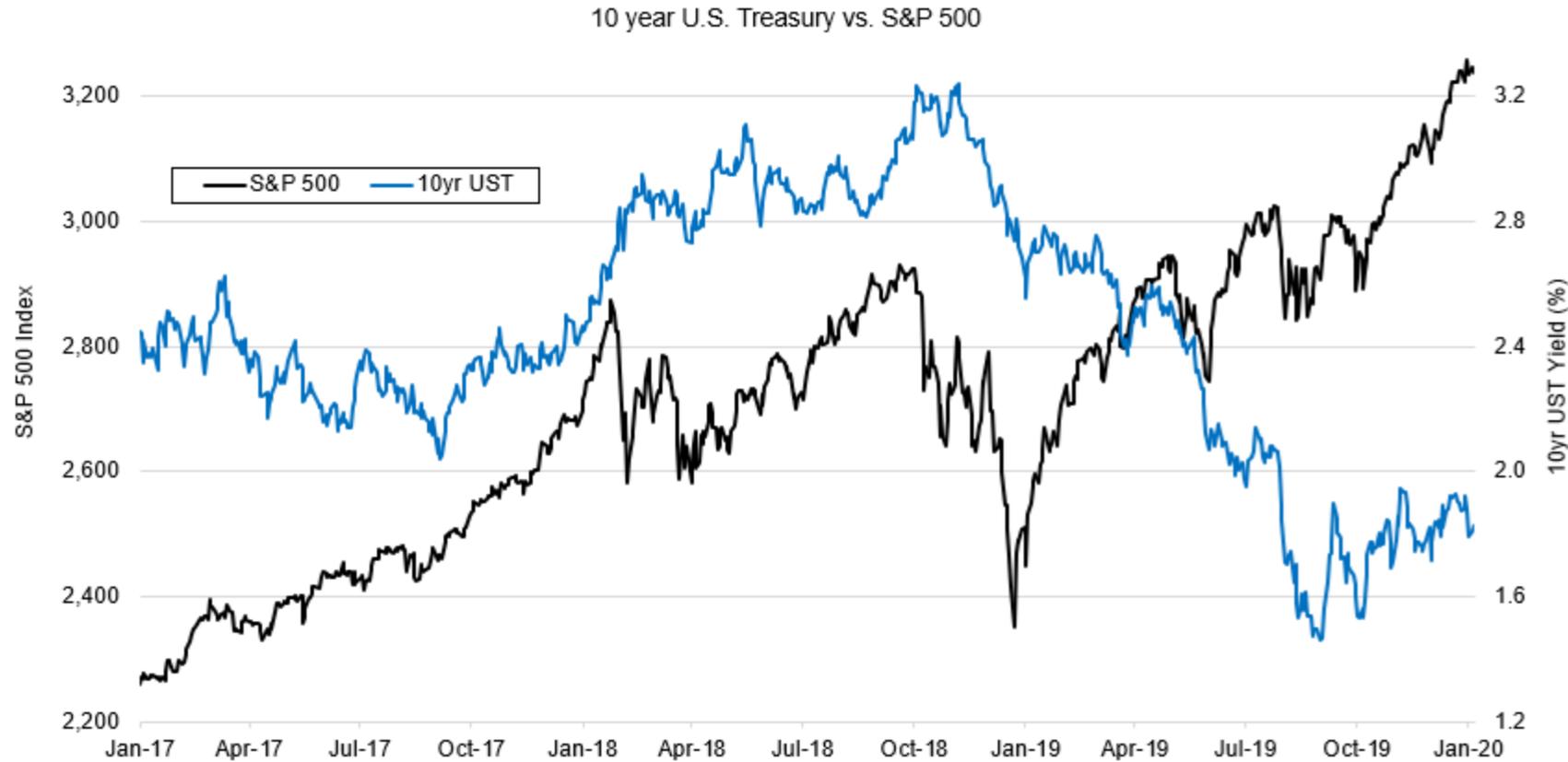


Source: Bloomberg, Smith Capital Investors as of November 30, 2019

- We warned about rebasing in 2019.
- Is inflation working its way through the system?
- Expectations and hard data continue to tell different stories.
- Globalization, technology, and demographics will all come into play.
- Global Central Banks will let inflation run hot.

# Theme 3 – Interest Rates

## *Another Year of Volatility and Uncertainty*

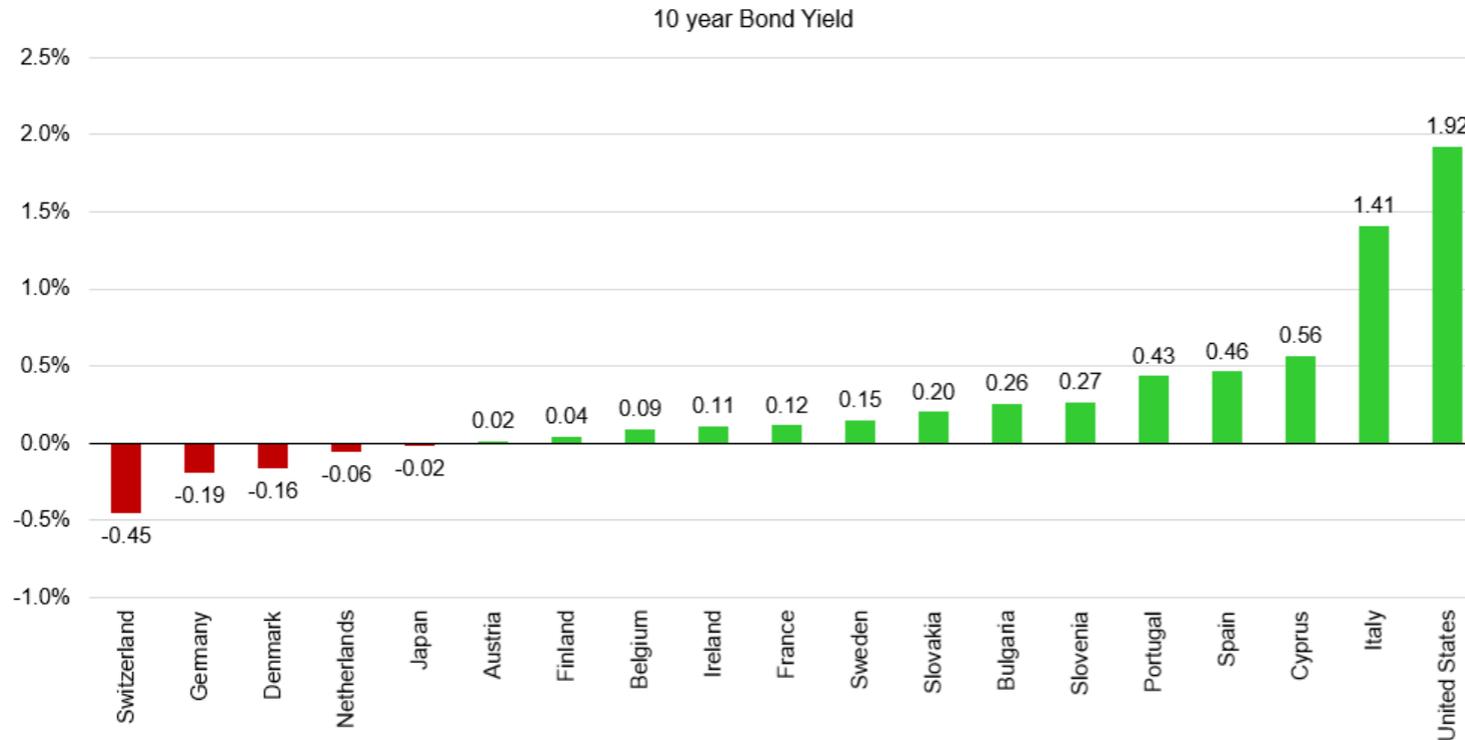


Source: Bloomberg, Smith Capital Investors as of January 7, 2020

- Remember the inverted yield curve?
- Mini-Cycles of rising and falling rates will continue in 2020.

# Theme 3 – Interest Rates

## *The High Yielding Country?*

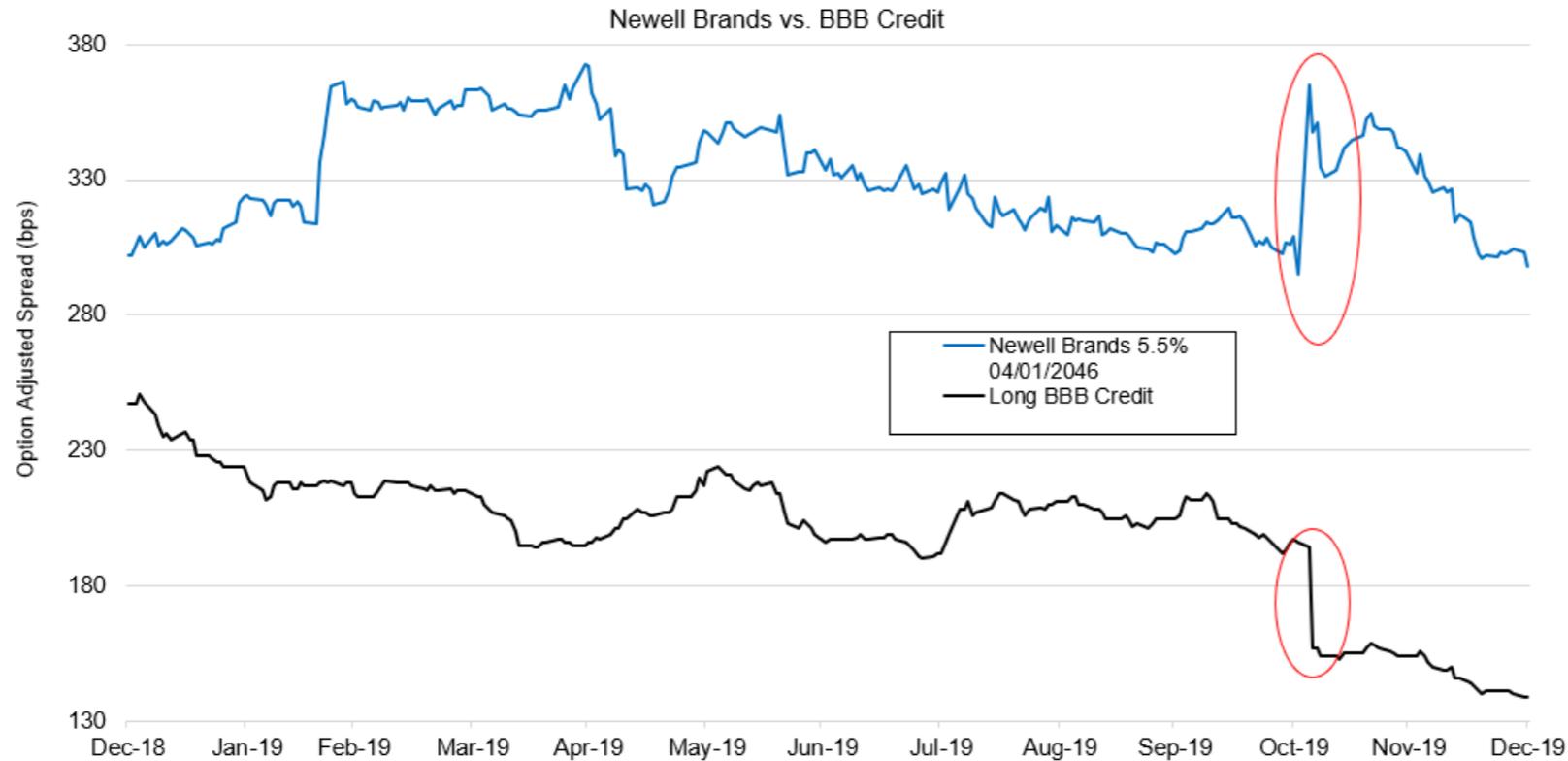


Source: Bloomberg, Smith Capital Investors as of January 7, 2020

- Pensions, Banks, Insurance Companies all have lower for longer problems.
- Why real rates matter, and negative interest rates make zero common sense.
- Fiscal policy path in play 2020.

# Theme 4 – Credit

## *The Have's and Have-Not's – Downgrades Matter*

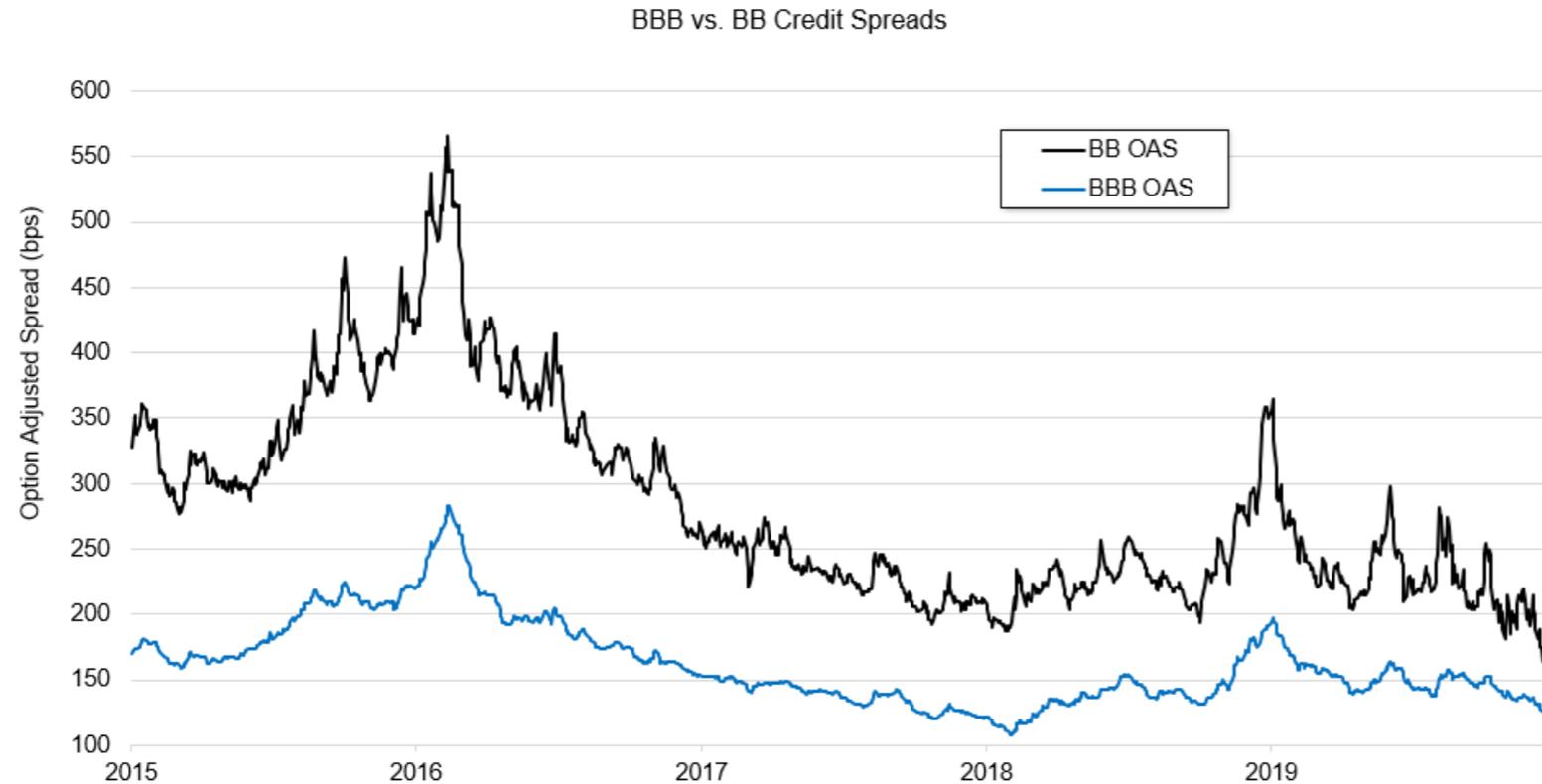


Source: Bloomberg, Smith Capital Investors as of December 31, 2019

- Downgrades will create volatility and repricing.
- The power of a strong capital structure.
- Why margins and FCF matter more today.
- Options are a CFO's best friend.
- Downgrades, upgrades and defaults.
- When Dividend yields are higher than 30-yr corporate bond yields.

# Theme 5 – Cost of Capital

## *Where is the Risk Premium?*

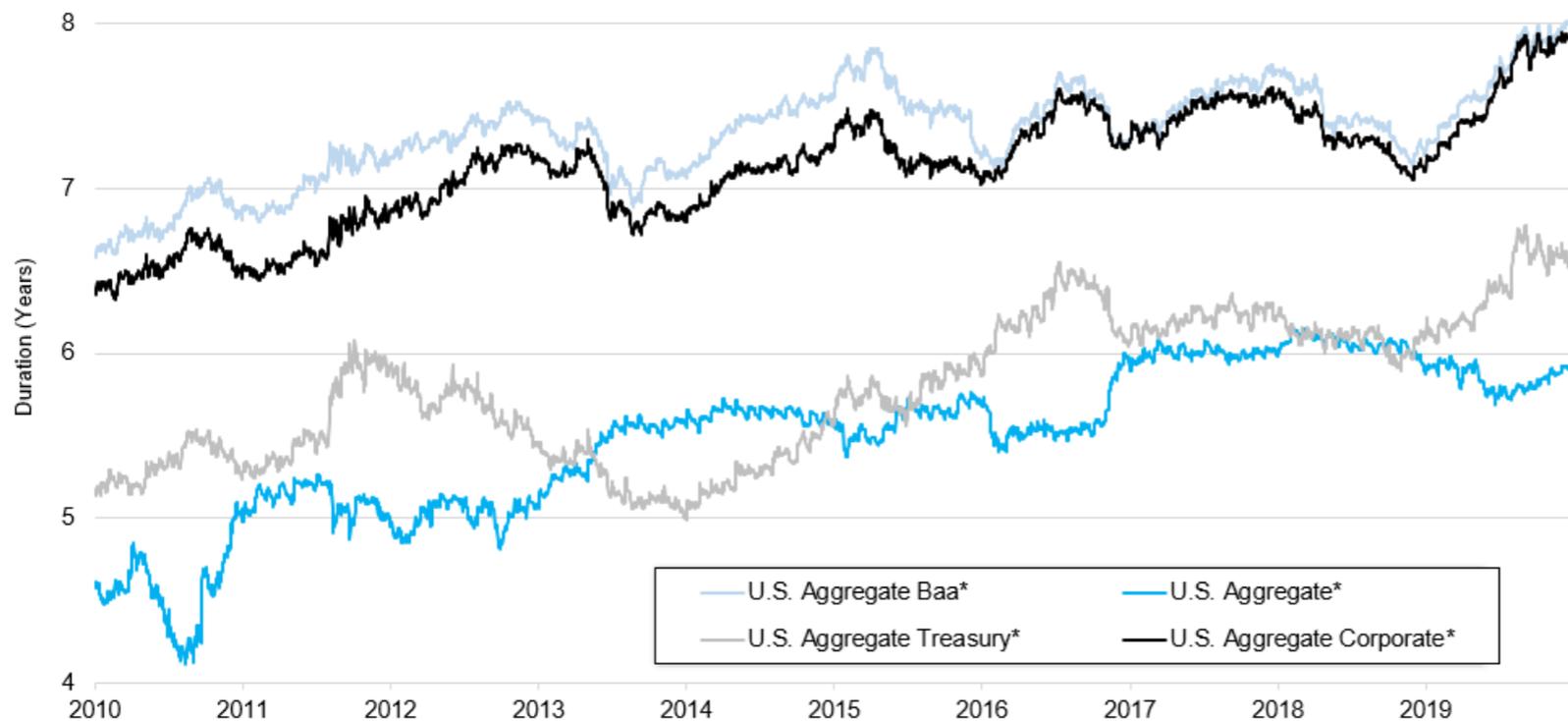


Source: Barclays, Smith Capital Investors as of December 31, 2019

- Leveraged finance in public/private capital markets.
- Loans, CLOs, and Private Credit.
- Shadow banking.
- Rational capital structure execution = enhanced returns and greater prospects... Or levered capital destruction?

## Theme 6 – Active Management

*Bloomberg Barclays U.S. Aggregate Duration Has Been Going Higher*



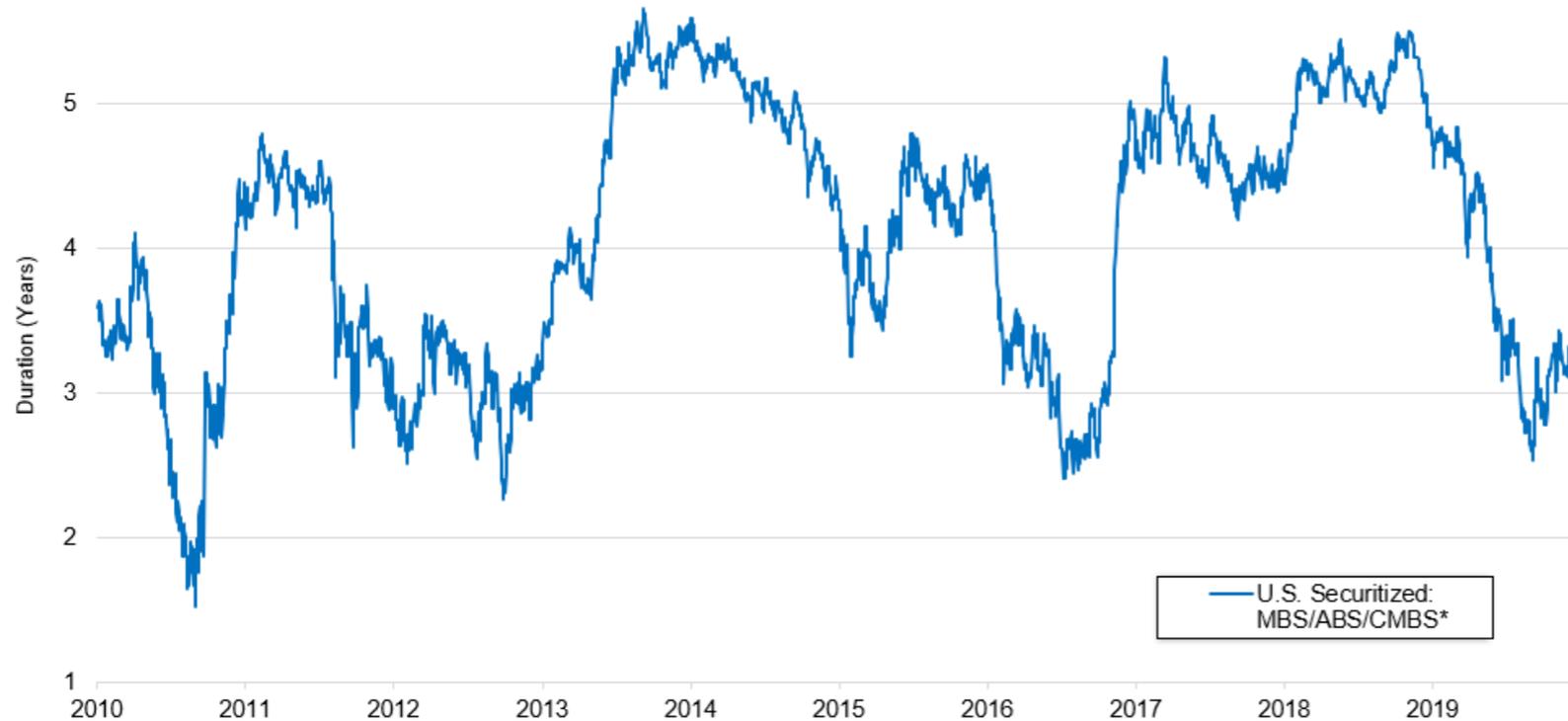
Source: Bloomberg, Smith Capital Investors as of December 31, 2019

\* All indices are Bloomberg Barclays Statistics Modified Adjusted Duration

- The power of ZERO.
- The math behind return seeking.
- The real issue = risk mitigation and capital preservation.

# Theme 6 – Active Management

## *Mortgage Duration Wild Card*



Source: Bloomberg, Smith Capital Investors as of December 31, 2019

\* All indicies are Bloomberg Barclays Statistics Modified Adjusted Duration

- Extension risk and volatility.
- Mortgage duration has ranged from 1.52 to 5.66 years over the past ten years.

# 2020 Wildcards: Smith Capital Investors View of What to Watch

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1. Rising Rates - Domestically and Globally (no more negative rates).
2. Change in Inflation and Inflation expectations - stagflation, acceleration, or deflation.
3. Negative interest rates touch every developed country. Pension funds, insurance companies, banks, and other financial institutions start the process of altering expectations around returns and risks.
4. Election Outcomes – significant regulatory change. Massive tax policy change.
5. China - Outright conflict with the U.S.
6. Fed and Central Bank Credibility comes into play. They lose control. Monetary policy viewed as completely ineffective.
7. Rating Agencies lose patience - significant downgrades including some top contributors to the credit index. The high yield market experiences significant disruption and repricing. The volatility flows into the loan market. CLO problems emerge.
8. European unrest - UK executes exit out of the EU. Italy and Greece start a similar process. France questions the viability of the EU.

# 2020 Wildcards: Smith Capital Investors View of What to Watch

(continued)

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9. Massive LBOs - Walgreens/Boots is just a start. Massive deals. Too much P/E capital.
10. Disruption in the leveraged finance markets - CLO problem. Equity wiped out, large mark downs. Spreads widen significantly.
11. Energy – significant decline in prices. Triggers significant downgrades and defaults.
12. FX - currency management programs finally breakdown (Swiss)
13. PE fails to successfully exit prior deals (IPO market closes, levered finance market closes). Large mark downs are realized by pension funds, endowments and high net worth portfolios. The infallible PE model is challenged. Reality hits that returns were all liquidity premiums and high leverage. Large redemptions of PE Capital due to poor results and liquidity concerns.
14. Stocks produce returns that rival 1999/2000 returns as large cash balances on the sidelines chase the equity markets higher in a true FOMO wave of hysteria.
15. Global recession – led by China. Reality Hits: China is just a levered growth machine
16. Geopolitical Risks accelerate

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