Asset Allocation Navigator

Fourth quarter 2018

The fourth quarter will be dominated by US growth momentum, the Fed 'normalisation' path for interest rates and politics – the Brazil presidential election; US mid-terms; Italian budget, Brexit and the US-China trade conflict. Each is a source of volatility but the fundamental backdrop is positive and in our multi-asset credit strategies we have reduced cash and selectively added risk, notably in European bank debt. Higher yielding emerging market 'hard currency' credit offers value in our view, but for now, we remain cautious on local currency debt. European credit fully discounts political risk, lower growth and the end of QE and there is room for spreads to tighten into year-end.

Momentum, normalisation and negotiation

The US economy enters the fourth quarter with impressive growth momentum, underpinning investor confidence and exuberant positioning in US risk assets. The Federal Reserve (Fed) is committed to the 'normalisation' of monetary policy with inflation at target and unemployment below its long-run rate. Moreover, the Trump administration concluded a replacement for NAFTA and is in trade negotiations with Japan and the EU.

In contrast, the eurozone economy has slowed largely due to weaker export growth but domestic demand, including investment, remains relatively strong and unemployment continues to fall. The European Central Bank (ECB) is far behind the Fed in unwinding the extraordinary monetary policies of the QE-era. It will end net bond buying in December but ECB forward guidance suggests that interest rates will not rise until late summer 2019 at the earliest. Similar to Europe, the Japanese economy is performing better than many investors appreciate, but rate hikes by the Bank of Japan (BoJ) are also a distant prospect. The BoJ has tweaked its 'yield curve control' framework, allowing 10-year JGB yields to move 0.1% higher and the scale of its asset purchases is declining.

The fourth quarter marks an inflection point in the transition to a post-QE investment regime. For the first time since 2009, the aggregate balance sheet of the world's major central banks will stop increasing and 'quantitative tightening' (QT) will start in earnest in 2019. Markets are entering the uncharted territory of QT that in our view is best navigated by strategies unconstrained by benchmarks and focused on capital preservation.

The Brazil presidential elections, US mid-term Congressional elections, Brexit negotiation and the Italian budget are potential catalysts for local market volatility. The tail outcomes of a 'no deal' Brexit and no Brexit are rising but a fudge that extends the process to 2020 remains the base-case. The Italian budget is likely to remain the centre of attention for European investors, but neither Rome nor Brussels (and Paris and Berlin) want a destabilising confrontation and in our view 'Italexit' risk is over-priced.

Geopolitical rivalry rather than a bilateral trade deficit is at the heart of the tensions between the US and its rival for superpower status, China. Escalation rather than negotiation is the watch-word for the US-China 'trade war' and

MARKET INSIGHT

David Riley
Chief Investment Strategist
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TACTICAL ASSET CLASS PERSPECTIVE

(3–6 month outlook)[1]

Global assets

	-		Neutral		+
Equity				■	
Credit		→	■		
EMD		■	←		
USD rates		■	←		
EUR rates			■		
Cash			■	←	

Credit

	-		Neutral		+
US IG		■			
EU IG				■	
EU HY			→	■	
US HY		■			
Loans			■		
Converts			■		

Emerging market debt

	-		Neutral		+
EMD Sov				■	
EMD Corp		■			
EMD Local		■	←		

investors will have to tread carefully to avoid being collateral damage.

Credit

Developed market (DM) credit generated positive total and excess returns in the Q3 as spreads tightened in response to strong corporate earnings. US high yield (USHY) spreads are at the tights for the current cycle, in part because leveraged issuers have been borrowing in the loan rather than the bond market. In contrast, the vast supply of debt by US investment grade rated (USIG) companies continues unabated despite its diminished attractiveness to foreign currency-hedged investors. The pattern is less pronounced but similar in Europe with net issuance in the investment grade (EIG) market while the high yield bond market is shrinking as loan issuance is robust.

We currently favour euro over US credit in light of relative valuations and performance. In our view, there is scope for spread tightening with investors too gloomy regarding European economic and political risks while the end of ECB bond buying is fully discounted. In our multi-asset credit (MAC) strategies, European bank contingent convertible bonds (cocos) are a key 'over-weight'. Convertible bonds remain a core holding providing rich alpha opportunities and the potential to generate attractive risk-adjusted returns as equity markets and core rates move higher.

Emerging market debt

Emerging market 'hard currency' sovereign and corporate debt out-performed local currency debt in the third quarter. Credit spreads modestly tightened against a backdrop of attractive valuations, especially in comparison with US high yield, and predictions of a 'systemic crisis' proved wide of the mark. The current bias across some BlueBay EM strategies is for higher yielding and oil-related sovereign and corporate credit. Turkey and Argentina have achieved some stability, albeit fragile, and the focus of investors is on the October presidential elections in Brazil.

We retain our preference for EM hard currency credit over local currency debt as the adjustment to tighter external financing conditions implies weaker currencies and higher rates. Moreover, an escalation of US-China trade conflict will place downward pressure on the value of the Chinese Yuan and EM currencies, especially in Asia. Nonetheless, many currencies are 'cheap', local bond yields are higher and there is value to be mined by active investors.

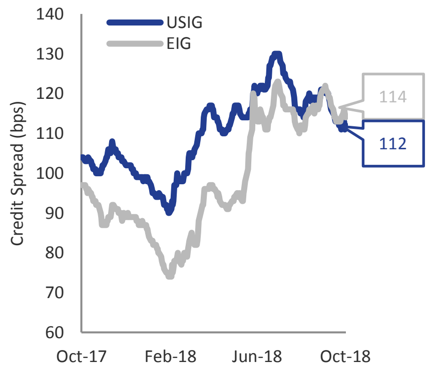
Rates

After holding a broadly neutral US duration stance for much of Q3, several BlueBay strategies entered the 4th quarter with a short bias. In our view, the likely end-point (terminal rate) for the Fed hiking cycle is at least 3½% while market pricing implies around 2¾%. The US economy is benefiting from strong growth momentum and is operating at full capacity, skewing inflation risk to the upside and incentivising the Fed to continue to raise rates every quarter at least into the second half of 2019. Against such a backdrop, some modest 'bear steepening' of the Treasury yield curve is not unexpected.

ECB monetary policy is currently on 'auto-pilot' and short-term rates firmly anchored by forward guidance that policy rates will not start to rise until the end of summer 2019 at the earliest. But there is room for modestly higher Bund yields as Italy risk dissipates and from the pull of US Treasury yields.

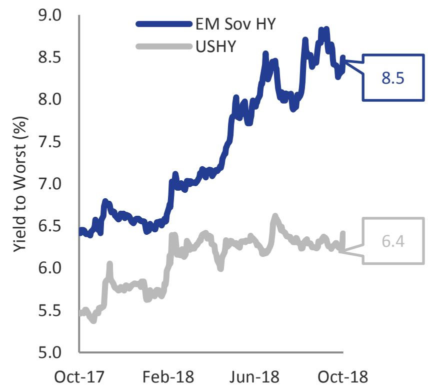
The BoJ de facto raised its 10-year yield target to 0.1% but a more meaningful shift is unlikely in the foreseeable future. For Japanese investors, European fixed income and credit is more attractive than the US on a yen-hedged basis.

FIG 1: US & EURO IG SPREADS



Source: BoAML, as at 4 October 2018

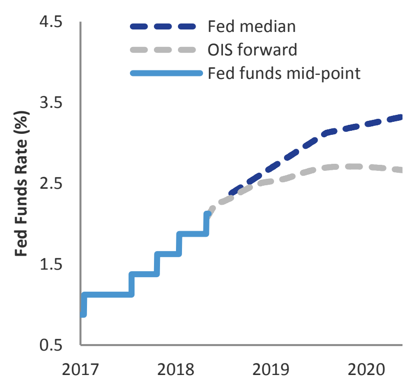
FIG 2: EM SOVEREIGN HIGH YIELD & USHY YIELDS



Source: JP Morgan; BoAML, as at 4 October 2018

Note: EM sovereign high yield is EMBI Global Div. non-investment grade index. USHY is BoAML US High Yield Master II index

FIG 3: FOMC RATE PROJECTION & OIS FORWARD CURVE



Source: Macrobond; Bloomberg, as at 4 October 2018

Note: 1 'Tactical asset class perspective' summarises the broad short-term tactical asset allocation views of BlueBay's Asset Allocation Committee and positioning across BlueBay's flagship 'blended' asset class strategies. The solid boxes reflect weights across asset and sub-asset classes (these 'weights' are indicative and do not relate to specific investment vehicles). The arrows indicate a shift in our tactical asset allocation since the previous Asset Allocation Navigator (3rd Quarter 2018 published in July 2018).