Asset allocation navigator Q2 2017

'Trumpflation' may have stalled, but global growth, and especially corporate earnings, continue to surpass market expectations.

Market insight

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With the French presidential elections passed and an ECB determined to nurture the recovery in output and inflation, we believe European assets are primed to outperform. Fears that President Trump would herald a lurch into protectionism have so far proved unfounded and emerging market economic and credit fundamentals are improving. In our multi-asset credit portfolios we have rotated from developed market high yield into emerging market debt. China and the oil price are the key risks to a continuation of the favourable environment for credit and emerging market assets.

Reflation vacation

Investors turned sceptical on 'Trumpflation' as 'hard' economic data failed to match the post-election surge in consumer and business sentiment. Nonetheless, the economy is at full employment and the Federal Reserve (Fed) remains on track to raise rates at least twice more this year, including in June.

In contrast, European economic data continues to positively surprise and the obstacle of the French presidential election has passed. European Central Bank (ECB) President Draghi also recently re-affirmed that monetary policy will remain highly accommodative through to year-end.

International trade and manufacturing rebounded sharply in the first quarter and emerging markets (EM) are benefiting from and contributing to the upswing in global growth. Improving economic and credit fundamentals render EM better placed to absorb higher US Fed interest rates.

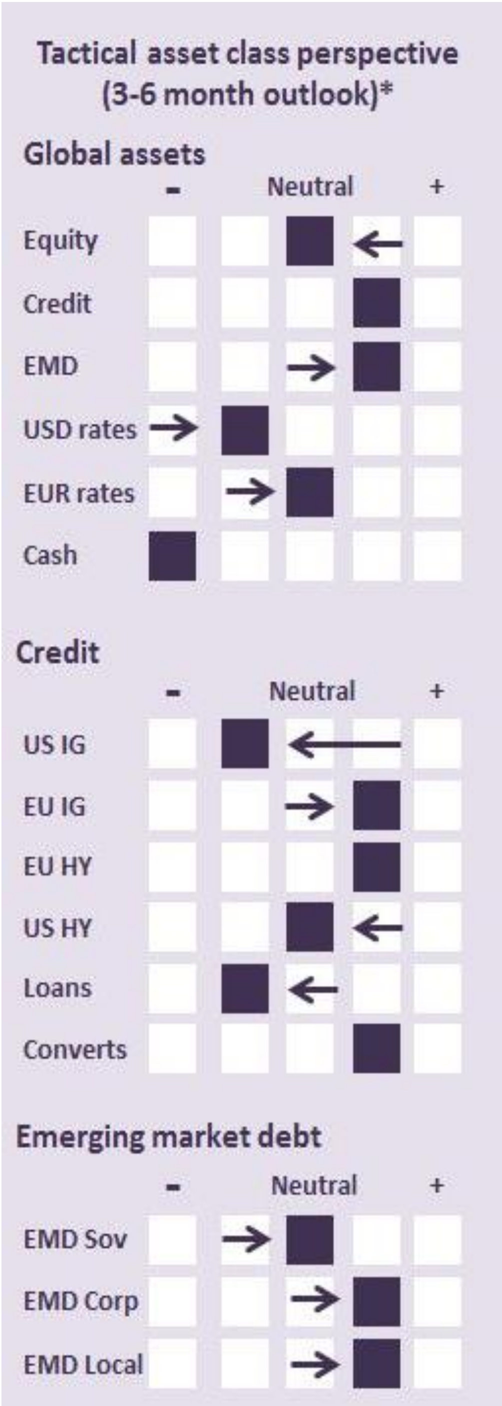
While investors may be too pessimistic on the prospect of US fiscal stimulus, the US dollar – a key global macro price – will likely remain range-bound until there is greater progress on pushing tax cuts through Congress.

A key macro price that is proving more wobbly than the US dollar is oil which is more than 15% down from its peak at the start of the year. We think that it reflects rising supply rather than signalling a downturn in global demand and in particular a sharper-than-anticipated slowdown in the Chinese economy.

The major economies, including China, enter the second quarter with positive growth momentum. Nonetheless, inflation pressures remain muted allowing central banks to maintain an ultra-easy monetary stance without investors fearing that policy is falling 'behind the curve'.

Global assets

A low interest rate, low volatility and moderate growth environment typically favours credit over more growth-sensitive equity. 'Safe' government bond yields are broadly unchanged since the beginning of the year and market volatility is at historic lows.



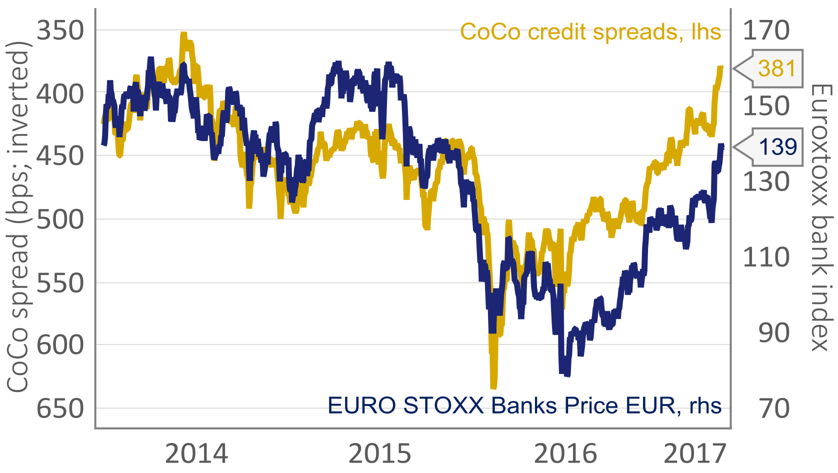
The current benign environment is anchored by central banks that remain biased to accommodation. Nonetheless, we retain our short bias on US interest rate duration as we continue to believe that the market is under-pricing the path of Fed rate hikes over the next 12 to 18 months.

The current 'carry-friendly' macro and market environment offers a potential opportunity to tactically rotate from developed market credit into higher-yielding EM debt. Now that the risks around the French presidential election have passed, and with economic data and corporate earnings continuing to surpass market expectations, European assets are well-placed for a period of outperformance in our view.

Credit

Low and range-bound intermediate and long-term government bond yields, low volatility and default rates render credit an attractive source of income in the current environment. Reduced political risk and economic growth and corporate earnings that continue to surpass expectations along with an ECB that does not want to tighten financial conditions creates a window for European credit to close the 12-month performance gap with US credit. We expect European 'credit compression' whereby hybrid and lower rated securities out-perform. European bank contingent convertible bonds (cocos) remain a favoured asset class in some of our multi-asset credit portfolios reflecting improving fundamentals and attractive valuations.

Fig. 1: European bank equity and coco spreads



Source: Euro Stoxx banks (SX7E); BoAML Contingent Convertible bond index (C0C0); data at 5 May 2017

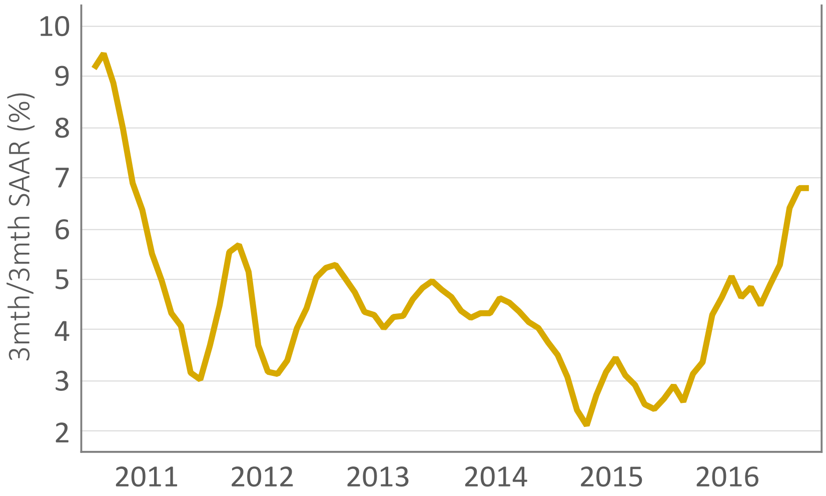
Increased bank lending activity and low funding costs are driving strong demand from CLO (collateralised loan obligations) managers for loans and issuers are taking advantage with higher leverage and weaker covenants. Moreover, loan prices near par provide little scope for capital appreciation.

Although loans offer relatively attractive risk-adjusted returns, we currently have a bias for high yield bonds over loans. In contrast, the recent strong performance of convertible bonds is expected to continue as both credit spreads tighten and equities grind higher.

Emerging market debt

Exposure to EM debt has increased across our multi-asset credit portfolios. The rebound in China activity and global trade as well as recovery in credit conditions in major economies such as Brazil and Russia underpins the broad-based and pronounced rebound in EM growth. Previous episodes of a widening gap between emerging and developed market economic growth have been associated with EM asset outperformance.

Fig. 2: EM growth upswing



Source: IIF EM growth tracker; latest month data at March 2017

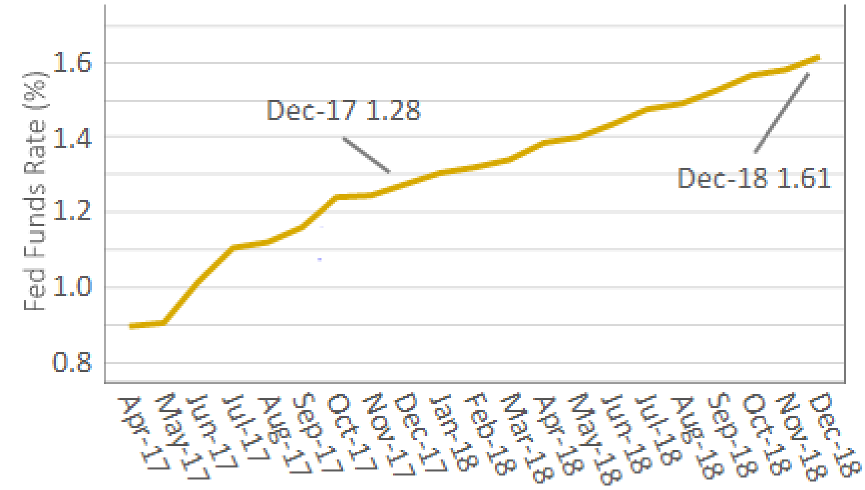
The improving economic and credit outlook for EM is attracting capital inflows, in part as investors acknowledge that fears that the new US administration would be aggressively protectionist in action as well as word have so far proved unfounded. Moreover, in our opinion EM assets offer greater value opportunities, notably in local currency bond markets as well as in high yield and distressed corporate debt.

Rates

US 'hard' economic data has so far failed to match the boost to business and investor confidence in the aftermath of the US presidential election. Despite a Fed rate hike in March and very likely at its meeting in June, the market continues to expect Fed policy rates to be 1.5% - 1.75% by December 2018, implying only two or at most three rate increases.

We expect some 'mean revision' in Q2 GDP after the low (preliminary) Q1 outturn and, with unemployment at an almost decade low, the bar for the Fed to deviate from its stated path of raising rates to more than 2% by the end of next year is high in our opinion. We therefore retain a bias to be short the front-end of the US interest rate curve while very low Bund and Japanese government bond yields will constrain the scope for US Treasury bond yields to move meaningfully higher in the near term.

Fig.3: Market expects three Fed hikes by December 2018



Source: Macrobond; BlueBay calculations; latest data at 8 May 2017

Although the ECB may drop its ‘easing bias’ from its forward guidance at its June meeting, we don’t expect the ECB to signal a substantive change in its current policy setting – 60bn euros of bond purchases and negative deposit rate – until its September meeting at the earliest. The scarcity of Bunds and negative rates will constrain the upward pressure on German Bund yields from the improving growth outlook and hence we retain a broadly neutral view on ‘core’ European interest rate duration.

* ‘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 funds). The arrows indicate a shift in our tactical asset allocation since the previous Asset Allocation Navigator (1st Quarter 2017 published in February 2017).