Asset Allocation Navigator

Fourth quarter 2017

Contrary to market expectations, the synchronised global economic upturn led by manufacturing and international trade gathered pace going into the fourth quarter. Growth-sensitive risk assets typically rally when the rate of change of growth is positive. And for now, at least, subdued inflation is allowing central banks to carefully calibrate the withdrawal of monetary accommodation without tightening financial conditions. Nonetheless, elevated asset valuations in developed markets, in particular, underscore the importance of identifying pockets of value and credit selection. Evidence of faster US growth, renewed hopes of tax cuts and potential change in the leadership of the Fed has pushed US Treasury yields and the dollar higher. We think that a long risk and short US duration bias is the most appropriate mix in our multi-asset credit strategies.

Market insight

David Riley
Head of Credit Strategy
October 2017

Speeding up

The latest raft of economic data confirms growth is accelerating and the global economy is enjoying the strongest and most synchronised upturn since 2010. Manufacturing is expanding in every major economy and global trade is growing at its fastest rate since 2011. Easy financial conditions, rebounding corporate earnings and rising global demand should drive a pick-up in investment spending necessary to sustain growth.

Falling unemployment and faster growth have yet to translate into rising inflation. Consequently, central banks are calibrating the scaling back of extraordinary monetary policies to minimise the risk of a disruptive tightening in broader financial conditions, including sharp falls in equity and credit markets. A 'risk aversion' market shock triggered by geopolitics is a key tail risk to the current favourable global economic environment.

Global assets

Growth-sensitive 'risk assets' - equity, credit and emerging markets – often respond more positively to the rate of change in global growth and earnings than the level per se. Despite elevated valuations across several asset classes, most notably in developed markets, we expect improving economic and credit fundamentals to drive risk assets higher into year-end.

The partial re-pricing higher of the path of Federal Reserve (Fed) policy rates has pushed US dollar and Treasury yields higher from their 'over-sold' levels in late Q3. With tax cuts back in focus in Washington and potential changes in the leadership of the Fed, the risk of a volatility spike is hedged by our short position in US short-term interest rate futures. But we don't expect a big move higher in long-end Treasury yields and a sustained rally in the US dollar that could prove more problematic for emerging markets.

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				■	←

Global Asset Management

Credit

Credit remains an attractive source of income against the backdrop of rising profitability and falling default rates. Emerging market and European (ex-UK) corporate credit fundamentals are improving. US corporate leverage continues to gradually rise, though corporate tax reform and cuts – if implemented – would support further spread tightening on US investment grade debt.

Pockets of value and increased spread dispersion, notably in US high yield, is also providing opportunities to supplement carry with active credit selection even with benchmark spreads at or near tights for the current credit cycle. European bank subordinated debt and corporate hybrid bonds continue to offer value in our opinion and the former in particular is a core allocation across a number of our multi-asset credit strategies.

We continue to favour high yield bonds over loans in light of the high share of loans trading near par and the rising leverage of loan borrowers, especially in Europe. Nonetheless, loans are an important component of the global leveraged finance opportunity set and in a rising rate environment will become relatively more attractive. Convertible bonds – another low duration asset – typically out-perform high yield bonds in an environment of rising equity markets and interest rates.

Emerging market debt

The manufacturing and international trade led acceleration in global growth is a very positive backdrop for emerging market (EM) economies and EM debt remains a favoured asset class in our multi-asset credit strategies. Inflows into emerging market assets from 'under-weight' international investors are on-going and in our opinion, there is room for further spread compression between EM credit and similarly rated developed market credit.

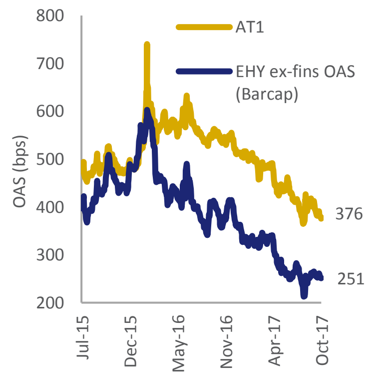
Falling inflation, relatively high real rates and steep local bond yield curves underpin the attractiveness of local currency debt despite its strong return performance so far this year. The partial re-pricing of the path of US interest rates and renewed hopes of tax cuts is pushing US rate expectations and the US dollar higher, prompting a small tactical reduction in the allocation to emerging market local currency debt in our multi-asset credit strategies. However, we do not anticipate a sustained upward trend in the US dollar, especially against emerging market currencies still far below their ten-year average value with improving economic fundamentals.

Rates

The Fed is on track to raise rates for a third time this year at its December meeting, in line with our expectation at the start of 2017. Once again, futures markets are pricing at most two more rate hikes over the next twelve months that in our opinion is likely to prove an under-estimate in light of continued above trend US economic growth, falling unemployment and the confidence of a majority on the Fed's interest rate setting committee (FOMC) that this will give rise to a pick-up in domestic wage and price pressures. Moreover, with four vacancies on the Board of Governors and Janet Yellen's term as Chair expiring at the beginning of February next year, any change in leadership is skewed to a 'hawkish' tilt at the Fed.

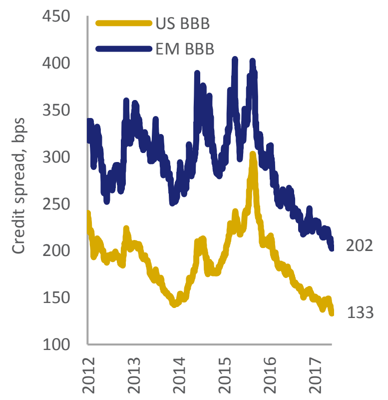
A sharp re-pricing of the path of Fed policy rates in our opinion currently poses the most meaningful threat to risk assets and consequently we retain our short position in US short term interest rates as a hedge to the long-risk bias in our multi-asset credit strategies. That said, forward rates on long-term bonds are more appropriately priced in our view and we expect further flattening in the US yield curve.

Fig 1: European HY ex-fins vs cocos spreads



Source: Barcap; latest date as at 3 October 2017

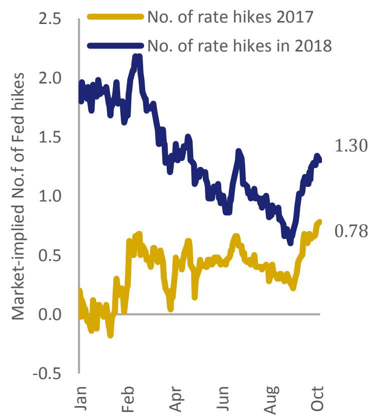
Fig 2: EM and US 'BBB' credit spreads



Note: JP Morgan CEMBI BBB index = EM BBB; BAML C0A4 BBB US corporate index = US BBB

Source: JP Morgan and BAML; latest daily data at 6 October 20172017

Fig 3: Market-implied No. of Fed rate hikes



Source: Bloomber, data, as at 9 October 2017

We expect the European Central Bank to only very gradually scale-back its asset purchases initially from €60 billion per month to €40 billion per month from January with further reductions likely to be delayed until the latter half of 2018 and policy rates to remain in negative territory until 2019. Negative short-term rates and a steep yield curve will continue to restrain the move higher in longer term bond yields warranted by the Euro area's improving fundamentals. In contrast, the deteriorating outlook for the UK economy and rising political risk will push UK rates higher over the medium-term.

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 funds). The arrows indicate a shift in our tactical asset allocation since the previous Asset Allocation Navigator (3rd Quarter 2017 published in July 2017).