Insights

Asset Allocation Navigator

Fourth quarter 2016

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Policy and political uncertainty is on the rise as the distortions from negative rates and quantitative easing (QE) become more apparent and persistently weak growth erodes support for the political status quo. Nonetheless, the near-term global growth outlook is improving and central bank bond buying has increased this year, supressing volatility as well as yields in core bond markets. Consequently, we remain fully invested across our multi-asset credit strategies and continue to rotate from leveraged finance into emerging market (EM) assets reflecting the improving fundamentals and attractive relative valuations of the latter.

Politics and policy

Policy and politics will dominate markets over the coming months. On November 8, we learn who has been elected as the most powerful politician in the world. On December 4, Italy votes on constitutional reform that if rejected could lead to early elections in the eurozone's third largest economy and home of its largest government bond market. And in mid-December, markets will focus on the European Central Bank (ECB) and Federal Reserve (Fed) for possible shifts in monetary policy.

The uncertainty regarding US economic policies and international relations, most notably with China, arising from a potential Trump victory will weigh on risk sentiment even though the market is pricing it as a one-in-four chance.

Monetary policy is also in transition as the limits of negative rates and quantitative easing are approached. The ECB has yet to provide clarity on if and how it will extend its current €80bn per month QE beyond March 2017. Divisions in the Fed on the timing and pace of US rate increases are also becoming more apparent. And in September, the Bank of Japan added a target for the 10-year Japanese Government Bond yield to its 'tool-kit'.

Nonetheless, central bank policy relief in the first half of the year, including stimulus by the Chinese authorities, is supporting a pick-up in global growth and inflation expectations. Near-term China 'hard landing' and US recession risks have diminished. Against this backdrop, markets are set to 'climb the wall of worry' into year-end.

Global assets

We currently judge that the current environment of rising policy and political uncertainty as well as anaemic global growth renders assets offering carry – reliable cash flow – more attractive than those dependent on future economic growth. We are 'under-weight' exposure to the most distressed segments of credit as well as convertible bonds. That said, we continue to look for opportunities to generate excess returns from idiosyncratic risk and relative value in our global credit, convertible and EM strategies. In our multi-asset credit strategies we remain fully invested and continue to rotate from global leveraged finance into emerging

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

market assets. We believe EM fundamentals are improving and relative valuations render EM assets attractive from a historical as well as absolute perspective.

Credit

The global search for yield incentivised by QE will continue to squeeze credit and liquidity risk premiums in developed credit markets. Nonetheless, in our opinion the room for further meaningful spread compression is diminished and future returns will mostly be generated from carry with alpha focused on capital preservation. US investment grade is the most liquid and highest yielding 'safe' asset (even after currency hedging) for Japanese and European investors starved of income at home. Even though US credit fundamentals continue to deteriorate, albeit at a gradual rate, we view risk-adjusted returns are moderately more attractive than in Europe where even some companies have been able to issue in the primary market with a negative yield.

The main shift in global leveraged finance within our multi-asset credit strategies is to reduce the exposure to leveraged loans. The shift is motivated by a desire to increase the overall liquidity of the multi-asset portfolios and an expectation that the asset class will under-perform its fixed rate peers given that loan prices are at or close to par.

In some strategies we have increased exposure to mostly European bank capital, including additional tier 1 (AT1) or coco instruments. In our opinion, bank capital offers attractive risk-adjusted income as banks face a squeeze on profitability rather than a worsening in credit fundamentals. Moreover, the regulatory and policy environment for banks is likely to improve as central bankers and regulators seek to offset the negative spill-overs from their policies.

Emerging market debt

The latest International Monetary Fund (IMF) economic forecasts confirm our expectation that the growth gap between emerging market and developed economies is set to widen, something that in the past has been associated with EM asset out-performance. Moreover, EM has largely adjusted to lower Chinese growth and commodity prices and stronger external accounts render EM less vulnerable to a repeat of the 2013 'taper tantrum'. We expect continued inflows into the asset class in light of the positive valuation gap between EM relative to developed market credit and fixed-income as well as the improving fundamental outlook.

We have continued to add emerging market debt such that across some of our multi-asset credit strategies, the relative exposure to emerging market debt is the greatest it has been since 2013. The 'under-weight' in emerging corporate debt has been closed as our assessment is that default rates have peaked and credit fundamentals are beginning to improve.

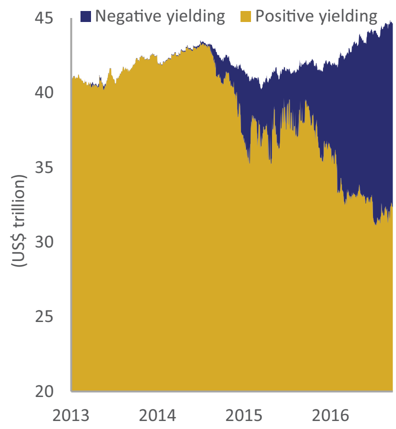
Rates

We retain our broadly neutral duration stance after reducing our long euro rates position in the aftermath of the Brexit-vote induced global rally in core government bonds. Yields have since been drifting higher as further rate cuts in Europe and Japan are discounted and a year-end Fed hike – our base-case - is gradually priced back-in. Moreover, the recovery in oil prices and China and global monetary easing earlier in the year is beginning to feed through into higher (market) expectations for inflation, including in break-even rates on inflation-linked bonds.

But we don't think the recent trend for higher long-term yields is sufficiently established to implement as a strong directional duration position across our investment strategies. Central banks are buying more than US$170 billion of government and corporate bonds every month. The shortage of positive-yielding 'safe assets' will likely cap the extent that core government bond yields can move higher and central banks remain extremely cautious in withdrawing monetary stimulus.

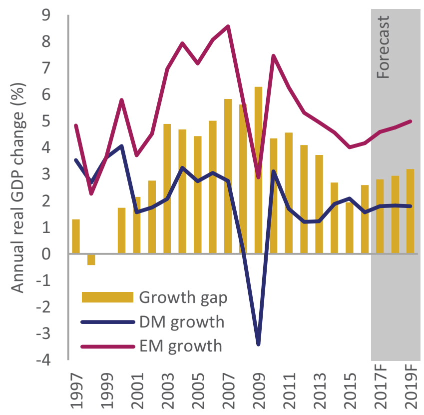
A theme for 2017 that could lead to steeper yield curves and much more volatility in core rates markets is a possible shift from monetary to fiscal stimulus in order to boost growth. But in our opinion, it is premature to position for such a shift in light of the powerful political and debt constraints on meaningful fiscal expansion.

Fig. 1 Negative yielding debt



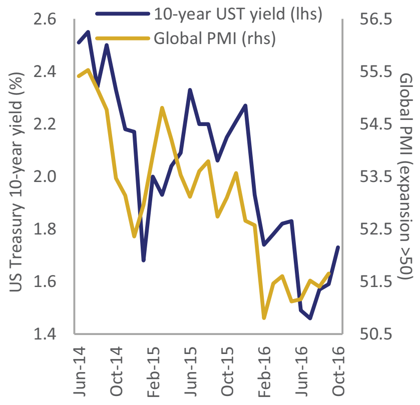
Source: BAML, as at 21 September 2016

Fig. 2 EM versus DM growth gap



Source: IMF World Economic Outlook, October 2016

Fig. 3 Global PMI and US Treasury yield



Source: Macrobond; data as at 10 October 2016

Note:

1 'Tactical asset class perspective' summarises the broad short-term tactical asset allocation views of BlueBay's Asset Allocation Committee. 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 2016 published in July 2016).

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