Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Emerging Market Debt Update
Weekly Update

July 11, 2019

A Critical Time for Markets

The mood music remains supportive for risk assets, but discernment is key.

Summary

Equities had another strong week, with the S&P and Eurostoxx leading the way and emerging markets lagging (although still in positive territory).

On the data front, US ISM numbers earlier in the week provided further evidence of the global slowdown, with the new-orders component of both the manufacturing and non-manufacturing indices declining. Later in the week, a stronger-than-consensus US nonfarm payrolls number printed at 224k, versus an expected 160k.

Somewhat counterintuitively, the stronger labour-market data provided the catalyst to halt the equity rally, rather than the weaker ISM data in the prior days, which had only served to fuel the rally. The explanation lay in the shape of the US rates curve, which went into bear-flattening mode on the better payrolls data – ie, the market began to price out some of the Federal Reserve (Fed) easing it had so aggressively priced in over the prior months.

In EM fixed income, returns were positive across the board, with spreads tightening in the hard-currency space, and little sign that the first dose of rates volatility in a while was going to upset the powerful ongoing yield grab.

Local markets were more nuanced, returning 65bps over the week, but with the rates component being the key positive driver, and FX weighing on returns given the late-week backup in US rates.

Market Review

- In Turkey, President Recep Tayyip Erdogan dismissed Central Bank Governor Murat Cetinkaya, given the latter's reluctance to cut interest rates. This move further damages the credibility and independence of the central bank. However, the reaction in markets was relatively muted, perhaps because the Turkish inflation profile is showing a convincing downward trend, and rate cuts are likely justified in the coming months anyway. All eyes are now on the S-400 missile system delivery, which is due this month and will draw the ire of US President Donald Trump.
- In Brazil, the pension-reform proposal may end up being approved by the lower house before the mid-year recess later this month. Popular support seems to have broken resistance to the reform and the chances of it being passed have increased meaningfully, as reflected in the sharp tightening in Brazilian sovereign spreads.
- Tensions in the Middle East remain high, with Iran exceeding certain limits set in the 2015 nuclear accord, while British special forces seized a tanker carrying Iranian oil in violation of European and US sanctions.
- Saudi Arabia issued EUR3bn in bonds as it sought to take advantage of the ultra-low yield environment in the European credit markets.
- The bonds of a Mexican oil company continued to chart a volatile path, with some recovery this week. The market awaits the release of the business plan, which is due on 15 July.

Market Outlook

We now approach a critical time for markets, with central banks having turned from patience to accommodation, and risk markets generally at the highs.

To make further gains we will need the Fed to affirm their dovish stance through actions, notably by delivering on the interest-rate cuts the market has priced in. Fed Chairman Jerome Powell's testimony to the House panel (10-11 July) should provide some guidance in this regard, with the market currently pricing a full cut for the July meeting.

What seems clear is that, despite a solid payrolls number, there has been a severe slowdown in global capital expenditure with trade uncertainty exacerbating the issue. We see this reflected in weak PMIs out of Asia, and persistent weakness in German industrial data (note the recent profit warning from BASF, which now forecasts a 30% decline in earnings).

In this regard, the second-quarter earnings season will be an important driver for equity markets, with the likely skew towards downside surprises given lofty (central-bank-inspired?) valuations.

In the current environment, we think there is enough justification for central banks to continue striking a dovish tone, and for core rates to consolidate around current levels. This should continue to support carry, with EM and credit benefiting.

However, recent spikes in volatility in both Turkey and Mexico are another reminder that credit selection is perhaps the most crucial part of investing at this stage of the credit cycle.

Index Review – Weekly Market Snapshot as of 07/05/2019

	Total return			Spread / yield change (bps)				
	Weekly	MTD	YTD	Weekly	MTD	YTD	Spread (bps)	Yield (%)
Hard Currency Sovereign	0.65%	0.65%	12.03%	-13	-13	-82	333	5.47
Hard Currency Corporate	0.36%	0.36%	9.53%	-10	-10	-52	307	5.03
Local Currency Corporate	0.28%	0.28%	8.28%	1	1	22	179	6.90
Local Currency Sovereign	0.32%	0.32%	9.07%	-10	-10	-87		5.59

Source: Bloomberg, JPMorgan

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