Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

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Too Soon to be Banking on the Doves?

Investors ponder the degree of central bank accommodation as speculation grows regarding the next moves of the Fed and ECB.

The rally in core rates took a breather over the past week, as bond yields moved higher on the back of stronger data and overstretched valuations.

The backup was short-lived in the US, as Federal Reserve (Fed) chair Jerome Powell hinted at a looming rate cut during his testimony to Congress. This was followed by Fed minutes from the latest meeting, citing heightened downside risks to the US economy from trade uncertainties.

The dovish tones meant the recent trend of bond and stock prices moving higher in tandem continued, with the S&P 500 surpassing 3,000 for the first time, pushing year-to-date gains to nearly 20%. However, stronger-than-expected core CPI data yesterday resumed the climb in US Treasury yields.

Let the speculation begin

With regard to central-bank policy, investors remain on tenterhooks as they try to anticipate the next moves of the Fed and European Central Bank (ECB). The main uncertainty is the degree of accommodation which will be presented in upcoming meetings.

In the US, there remains a dichotomy between steady growth and a strong labour market on the one hand, and tepid inflation and growing political pressure on the other, but we continue to believe the US economy is in good shape.

By contrast, the nearly 100bps of cuts priced into markets over the next year is more consistent with an impending recession, which we do not foresee. For that reason, we continue to see asymmetry in playing rates from the short side over the medium term.

In Europe, data continues to disappoint, adding fuel to expectations of monetary easing from the ECB later this month. With risks stacking up, talk from ECB members has pointed towards a monetary-stimulus package in coming meetings, with rate cuts, interest-rate tiering for banks, and another round of QE all on the table.

Election round-up

On the political front, Greece went to the polls for the fifth time in a decade, with centre-right party New Democracy winning with a landslide victory.

The new prime minister, Kyriakos Mitsotakis, is an experienced operator, who has promised voters tax cuts and increased investment. We believe his credibility will only reinforce the ongoing rehabilitation of the Greek economy.

On that basis, we continue to favour Greek government bonds, given strong EU institutional support, improving economic fundamentals, and the prospect of inclusion in the ECB's PSPP programme down the road.

In fact, the European periphery in general still offers value in a world where fixed-income investors are being repressed by the growing stock of negative-yielding debt, with Italy and Greece the two standout issuers on a valuation basis.

In the UK, Brexit continues to dominate news screens, despite the new deadline of 31 October still being months away. This past week saw two key developments: a more definitive Brexit position set forward by the leader of the opposition, Jeremy Corbyn; and the race to become the new prime minster entering its final stages.

On the former, the Labour party will now endorse a 'remain' position should a second referendum materialise, or alternatively, negotiate and endorse their own deal, should the opportunity arise via a general election.

On the latter, Boris Johnson is now almost certain to be the next prime minister, having the support of most of his party's members, but his 'do or die' stance on meeting the 31 October deadline could also be his undoing.

We continue to believe that a Brexit impasse will lead to another general election this autumn, with a growing probability of a Labour-led coalition government by the end of this year.

In this case, we believe that Gilt yields could move materially higher, and until then, uncertainty will continue to hit the pound, which is now sitting at a two-year low versus the US dollar.

Tough love at DB

The European financial sector was firmly in the spotlight over the past week, as Deutsche Bank (DB) finally announced its long-awaited restructuring plans. Unlike previous iterations, it appears to have some teeth to it.

In our opinion, the market loves to hate DB, and having seen multiple plans come and go, management clearly have to prove that they can execute.

That said, we have never been of the view that DB was a major credit risk. Liquidity is extremely robust, capital is appropriate, and in our analysis the balance-sheet risk is overstated.

The announced plan will reduce risks further and start the process of tackling what we view as the key issue – namely the enormous cost base and the lack of a focused strategy.

As such, while the equity and AT1 will remain show-me stories that will continue to be volatile for some time, as management execute the plan, we view the more senior parts of the capital structure as offering an attractive premium, at a point where investors are failing to disaggregate the capital structure.

More generally, we maintain a constructive stance on European subordinated financials, where we see valuations as compelling and credit quality on an improving trajectory, with non-performing loans declining, and capital ratios continuing to improve.

Elsewhere, a profit warning from the world's largest chemical bellwether, BASF, was also topical and weighed on cyclical risk sentiment. The company cited much slower (than expected) growth in global industrial production, especially within the automotive sector, and signs of slowing in China.

Having recently witnessed profit corrections and growth-outlook cuts in multiple European industrial sectors – including electronics, process automation, automotive, chemicals and plastics – the million-dollar question remains: to what extent is this structural versus cyclical?

The upcoming second-quarter earnings season, and especially forward guidance from company management, will be closely watched to shed better light on that question, as well as the fundamental state of affairs at a more micro level.

Looking ahead

Looking ahead, having cleared potential hurdles such as the G20 and the Powell testimony, we are inclined to believe that markets can continue to climb the proverbial wall of worry. There is a clear sense that investors remain overly pessimistic on the global macro landscape, and as a result underinvested.

So, as we embark upon the quiet of summer, with volatility subsiding, it is plausible to us that risk assets can continue their ascent higher, underpinned by accommodative central banks.

Of course, the risk is that the market has prematurely priced in the dovish central banks. In reality, our sense is that central bankers have mixed views on what to do next...Maybe for a change the UK government (NHS) have the answer – Ask Alexa!

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