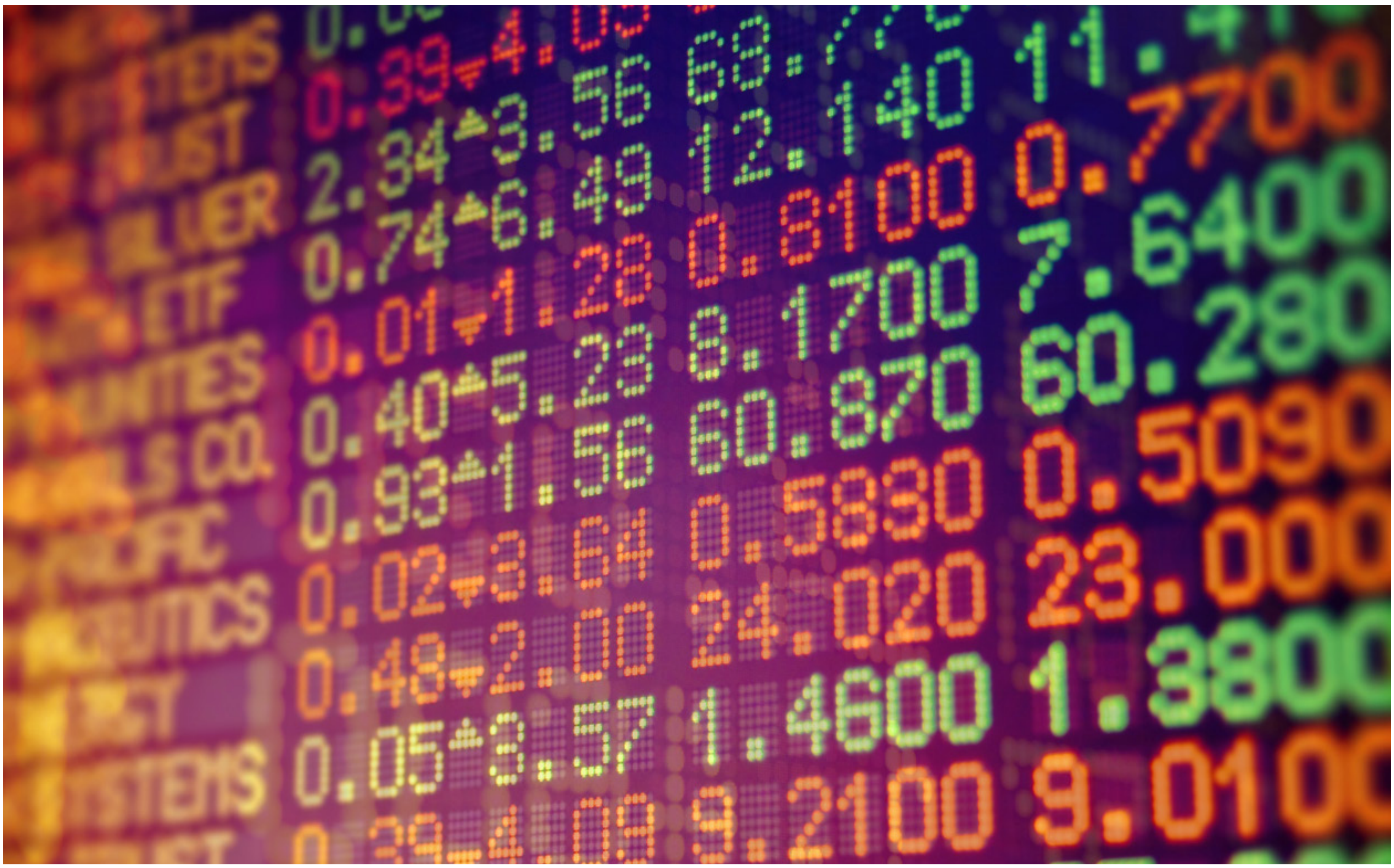
RBC Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

August 9, 2019



Cut Debt Levels by Issuing More Debt?

Welcome to the mad world of 2019.

As trade tensions escalate, government bond yields have rallied to new lows on fears of rising recession risk.

At the start of the week, China announced it was halting the import of US agricultural goods and symbolically allowed the Chinese renminbi to depreciate below 7.0 versus the US dollar. This then led the US Administration to label China a 'currency manipulator'.

Although this step was symbolic, it may appear that, in the near term, both Washington and Beijing are putting themselves in positions that will be politically difficult to row back from.

US equities fell sharply on Monday and have remained relatively volatile since, while in interest rate markets, economists have been rushing to downgrade forecasts, notwithstanding Powell's relatively sanguine messaging only a week ago.

In the US, there are now 35bps of rate cuts priced to the end of September and 75bps priced to the end of the year, with further cuts discounted into 2020. This appears to fully discount a very bearish outcome and we struggle to see the Fed delivering any more than this.

However, the short term is fraught with uncertainty and were global stock markets to fall sharply following a collective loss of confidence then, predictably, monetary authorities would seek to restore calm.

Recession risks

We continue to view a US recession as very unlikely. However, in the eurozone, the threat of recession is much more real. In particular, it appears that the manufacturing sector is very much in recession already and further PMI and orders data in Germany compound this view, even if the backdrop in the service sector appears healthier.

As such, expectations for ECB monetary easing are very much understandable. A rate cut of 20bps in September is now widely expected, along with deposit tiering plus possible news on re-starting the QE programme.

The desire to throw the kitchen sink at the problem is understandable, given that the meeting will be Draghi's last hurrah, and that it may be easier for him to deliver any contentious policy moves prior to Christine Lagarde taking office.

That said, in European policy circles (and further afield) there is a widespread acknowledgement that cutting rates when they are already in negative territory and delivering further QE can't do too much to improve the economic outlook. Fiscal policy easing is required and, in this respect, Germany remains conspicuously intransigent in its desire to enact meaningful stimulus.

Germany's love of a black zero

An obsession with a 'Schwarze Null' representing a balanced budget seems to be missing the point. It appears that Berlin has failed to grasp that in the Alice in Wonderland world, where yields on German bonds are well below zero along the entirety of the yield curve — then a government can actually reduce its debt stock by issuing more debt.

Germany could stop collecting all taxes for a couple of years if it wanted to do so, only for government finances to end up in a stronger fiscal position. While these statements scarcely seem like they can make sense, this is the reality of where we find ourselves today with 10-year Bunds at -0.6%.

Meanwhile, we would observe that the decline in yields is creating the 'dark star' effect in the eurozone, which we have written about before. A hunt for any positive yield is seen pulling curves flatter and spreads tighter. Consequently, even in a world where flight to quality has impacted risk assets, euro credit spreads have been well behaved. This is a phenomenon we believe can continue.

In Italy, spreads widened substantially this morning on news of a potential collapse in the government. The prospect of a government just consisting of La Lega (or with the more right wing extreme Brothers of Italy party), has been taken badly on initial readings. However, we don't see such an outcome making an EU break-up any more likely.

We have read Salvini as a populist, who wanted to clamp down on immigration and see reform within the EU, rather than someone who would like to leave it. Indeed his desire for a more accommodative fiscal stance appears to be consistent with the direction of travel in Europe, and his stance of fiscal policy seems much less at odds with the rest of the EU than may have been the case 12 months ago.

Consequently, a widening of spreads may represent a buying opportunity — even if the newsflow from Italy may make for some uncomfortable headlines on the presumption that we will be in an election campaign for the next couple of months.

UK deal remains up for debate

The UK backdrop has been relatively quiet over the past week with most policymakers away on holiday. There has been debate as to whether a 'No Deal' Brexit on 31 October can be stopped.

We remain confident that it can be and will be — and suspect that this isn't really an outcome that Johnson or many around him actually want. We are inclined to think that they would like to be able to blame others in Brussels and Westminster for a further delay and fight an election on the grounds of 'The People' versus 'The Politicians'.

We suspect an early confidence vote when Parliament returns could be the trigger to a general election and so we continue to believe that the recent decline in Gilt yields will be unsustainable, in light of the upcoming political risks.

Both the Labour and Conservative parties seem committed to raising government spending (the former, dramatically so), while a Labour coalition outcome could yet see a further referendum and Brexit scrapped altogether.

Against this backdrop, we believe that the Bank of England will be much less inclined to cut rates than other central banks. Regarding the pound, it is possible that opportunities in sterling may switch to the long side before we reach Q4 this year.

Thoughts on positioning

In the near term, uncertainty reigns and it is hard to predict whether Trump's next tweet will seek to restore relations with Beijing or offer further threats and admonishment.

It would appear that the path of the US equity market is key to this and having fallen sharply, this has started to stabilise — in part thanks to support coming from lower rates forecasts.

Were equities to rise, this could possibly embolden Trump in his tough stance, whereas a dip could see him adopt a more conciliatory tone. Given that the presidential election in 2020 is at the centre of his thinking, the one thing that Trump knows is that he cannot afford an economic downturn.

The healthy US economy has been Trump's strong suit and the thought that his direct actions are putting the growth outlook at risk is certainly not lost on those advising him.

Of course, there is a sense that by taking a more hawkish stance on trade, Trump is simply twisting the arm of the Federal Reserve to deliver more monetary accommodation in line with his desires, yet this is a very risky tactic if this is indeed part of some Machiavellian masterplan.

Looking ahead

It seems difficult to invest in some assets with much certainty for now, but there are opportunities we feel that are possible to identify by taking a slightly longer-term view.

Firstly, we believe that the market is pricing too many US rate cuts to the end of next year. Fed funds sub-1% seems only likely in a recession and this still seems unlikely given fiscal and monetary accommodation to-date and a strong outlook for the domestic economy. In that way, maintaining a bias to be short in rates makes sense from an asymmetric return point of view.

Secondly, we can observe in Europe that growth is already much weaker than in the US and so the need for additional stimulus is already more obvious. Policy easing is likely to drive curves flatter and spreads tighter as investors hunt yield on investment-grade assets not exposed to default risks associated with the risk of a recession.

In this light, we continue to have a favourable view on sovereigns such as Italy and Greece, other long-dated sovereign issues and sectors such as financials, with banks in a very strong position to weather any downturn having de-risked balance sheets in this cycle.

We also believe that the UK offers scope for volatility and opportunity into the end of the year. We have been short of Gilts versus the eurozone periphery this year and feel this trade has further to run.

In many respects, it can feel like we are operating in an uncertain and confusing landscape — who wants to buy 5-year Germany at -0.8%? How can raising debt lead to falling debt levels? What is the future of the eurozone (and Japanese) government bond market, with USD14 trillion of assets now offering negative yields and more duration than ever before?

These are all interesting questions to ponder, and we would observe that the reason that many investors allocate to fixed income is in order to see low volatility, preservation of capital and returns that are better than inflation and cash over the medium term.

In this context, 2019 has been a great year of beta returns for fixed income indices — but at some point, benchmarks are destined to deliver disappointing performance — such is the math of fixed income.

But where there is volatility, there will be opportunities to deliver active returns by deploying skill.

In this context, we may live in a mad world out of Alice in Wonderland where we have gone down a metaphorical rabbit hole and everything is upside down…but we have reached an unstable equilibrium and we can't see it lasting into the longer term.

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