Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

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Blackest Darkness behind us and bold predictions for 2019

The run up to Christmas has been a challenging period for risk markets, but with the point of Blackest Darkness now behind us, sentiment will brighten and flight to quality will ease.

With US equities enduring the worst December since 1931, flight to quality fears have pushed government bond yields lower on building worries for the global economic outlook. However, we strongly believe that markets have been driven by quant driven funds chasing trends in the past month and that it is short-sighted to believe in a recession type of narrative based on this price action.

Real economy

In the real world, the US economy continues to enjoy strong growth (the Atlanta Fed Nowcast of GDP is around 3% in Q4) and demand is likely to be given a further push in H1 2019 as tax filings lead to rebates, which will boost consumer incomes that are already growing thanks to growth in jobs and wages. In the eurozone, meetings with policymakers this week emphasised the relative strength of domestic demand in the eurozone and with fiscal policy moving in a more expansionary direction, this also seems likely to support economic activity in 2019. Meanwhile, Chinese policymakers continue to ease both fiscal and monetary policy and we see a upturn in infrastructure spending limiting the downside risks to growth in the months ahead.

Powell disappoints

Notwithstanding this, it appears that the only topic of conversation relates to downside risks and this was very evident at the Federal Open Market Committee (FOMC) press conference this week, with chair Jerome Powell giving a relatively disappointing performance. The Federal Reserve (Fed) statement remained more bearish than markets would like to hear, with the FOMC continuing to see higher rates through 2019 and 2020 in contrast to markets, which now want to start to price the next rate move as a cut, not a hike. Yet, this being the case, it could be argued that the Fed chair should have been more confident and upbeat concerning growth prospects to help dispel market worries and instead markets have wanted to conclude that the Fed is making a policy error. In this regard, it seems that European Central Bank president Mario Draghi was much more convincing in talking up growth the week before, but ultimately hard data may be needed to convince the growth sceptics.

In this context, the recent rally in rates has gone against our view, where we have been positioned short in duration in both the US and the UK. However, we continue to hold a lot of conviction in this view and firmly expect a data dependent Fed will continue to hike three times during 2019, following the four moves we correctly projected during the past year.

Parallels with the 2015/16

With oil prices dropping there has been discussion of parallels with the 2015/16 period, but we feel that such talk is misplaced, noting that the ISM survey dropped to a low of 48 during this period, but currently sits close to its cycle high above 59. Recession is not currently on the cards and we continue to attach ourselves to the Fed narrative that economic cycles don't die of old age, they roll over when policy becomes too restrictive – and in this regard would point out that, although measures of financial conditions have tightened in 2018, they remain at the average for the past five years and at a more accommodative level than was the case when the Fed started hiking at the end of 2015.

Waning political risk

In other developments, we have been encouraged to see a decision on excessive deficit procedure (EDP) measures with respect to Italy placed on hold, as the dialogue between Brussels and Rome continues to grow more conciliatory. Italian bond (BTP) spreads have rallied back to September levels as the perception of political risk continues to wane and in our assessment, Italian growth rather than politics may be where most of the risk lies in the year ahead.

Fundamentally, we would see fair value for 10-year BTPs close to 180bps versus Germany, but perceptions around risk and volatility will probably make it difficult for BTP spreads to trade inside 225bps for the next few months, unless there are positive developments – such as new elections which could see La Lega govern the country with other parties on the right, disposing of the Five Star Movement, who have shown themselves as inept and incompetent in office to date.

Elsewhere in Europe, the perma-Brexit shambles is set to run into the New Year, the French yellow vest protest movement seems to have run its course and in Sweden, it was interesting to see the Riksbank hiking interest rates for the first time since 2010 – again serving a reminder that not all in the world is as bad as some may want to believe.

Asymmetric opportunity

As described above, we feel that the current market pricing of US rates is wrong and taking a short position currently offers a compelling asymmetric opportunity. In the UK, our Brexit narrative looking for an increase in tensions before a possible stop to Brexit remains intact. In the short-term, we see opportunities in the UK by being short the pound, but medium-term also see scope for substantial alpha by adopting a short position in Gilts. In the euro periphery, we believe that spreads in Italy and Greece remain wider than they should be, as we see eurozone break-up risks as remote, with EU policy makers remaining as committed as ever. In credit, the cheapening of valuations also creates opportunities with default rates set to remain very low in quarters to come, even if short-term worries related to excess supply can continue to weigh on the market.

Elsewhere, we see Iceland as an interesting story in January, with the government close to ending capital inflow restrictions, which could see local rates and the krona rally materially. In this context, we believe that we may need to wait until the New Year for our Christmas presents to arrive – but we are confident that they will be delivered; even if we would have liked them a bit sooner.

Bold predictions for 2019

As we hit the winter solstice, we would reflect that the point of Blackest Darkness is now behind us. Sentiment will brighten and flight to quality won't persist. For those of us in markets, it has felt a very un-Christmassy run-up to Christmas, but before signing off for the year, feel it is time for a few fun predictions for the year ahead:

- US GDP growth to exceed 2.5% in 2019, powered by the mighty US consumer, with the Fed hiking rates three times during the year
- EU elections to cement the end of Germanic austerity, as expansionary fiscal policy is used to push growth and drive closer eurozone integration
- Corbyn in 10 Downing Street is more likely than Brexit being delivered in the year ahead
- Bitcoin to be the worst performing financial asset for the second year in a row
- Manchester United to sack at least one more manager in 2019 as trophy hunting fans desert the Reds for Liverpool & Manchester City

Due to vacation, the next weekly commentary is likely to be sent out on January 11. In the meantime, I would like to wish everyone reading these notes a very Merry Christmas and a happy & prosperous New Year. Best wishes!

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