Portfolio Manager Perspectives
BlueBay Investment Grade Debt Update

September 28, 2018

Are They Taking the Pizza?

Brits continue to flirt with a hard Brexit scenario, while Italy weakens on unexpected budget news.

Italian budget news has occupied centre stage in financial markets over the course of the past week. On Thursday evening, policy makers from La Lega and the Five Star parties agreed on a budget deficit target of 2.4% for 2019 and subsequent years, which was higher than the target that Finance Minister Tria had been pushing for. This led to weakness in Italian assets on fears that this sets the stage for renewed conflict between Rome and Brussels, and it is likely that the EU Commission will push back on the plans later in October following the submission of further details.

Nevertheless, Italy will continue to maintain a healthy fiscal primary surplus under these plans and although the debt/GDP ratio will not decline as Brussels would like, it seems unlikely to rise either – though ultimately progress on this front will probably be more dependent on the growth outcome than the fiscal delivery. Rating downgrades to low BBB also seem quite possible, if not likely – yet we think Italy remains in a much, much better position than was the case in 2011/2 – a period during which its investment grade status remained intact. Consequently, we don't see a scenario where this is called into threat at any point in the foreseeable future.

Moreover, we have articulated on a number of occasions that when we assess value in BTPs, we find ourselves assessing the probability of an 'Italexit' from the single currency. We continue to see this as a very low probability and don't see any substantial support for this from the general public nor the political parties within the country. We had hoped that following the Italian budget that Italian 10-year spreads would move inside 200bp and although this seems much less likely to be the case, a sustained move wider from current levels would also seem unjustified with a steep yield curve making it an expensive short to maintain.

A change of (budget) plan

In May, original government budget plans suggested an eye-watering deficit of more than 6% of GDP and an outturn of 2.4%, which is below the 3% Maastricht limit and seems far from the disaster that Italian bears would like to suggest that it may be. In many respects a few tenths of GDP means little in the grand scheme of things in a sober analysis of debt sustainability – though what provokes much more fear is that Italy and the rest of the EU are on a collision course, with Rome spoiling for a fight and financial markets the potential casualty.

In this context, Italian newsflow in the next few days will be very important and it will be interesting to see how markets react to this.

Arguably, there is a case that with so much bearishness already dominating the media and embedded in financial markets, there could be a moment when investors sell the rumour and buy the fact – though in the early aftermath to announcements it seems that it would not be wise to jump to hasty conclusions.

Economic boom keeps US on a steady path

US Treasury yields edged lower following this week's FOMC meeting, but were little changed over the week as a whole. The Fed moved its target band for the funds rate to 2.0% -2.25% in its eighth quarter-point hike of the current cycle, going back to 2015.

Although explicit reference to policy remaining accommodative was removed from the accompanying Fed Statement, Chair Powell acknowledged that rates remain some distance from the perceived 'neutral' rate, and that with monetary conditions supportive and the economy booming, the Fed should continue on its path of monetary tightening well into 2020, unless the economy disappoints.

With the Atlanta Fed 'nowcast' of GDP running above 4% (as it has for the past six months), and with the impulse from fiscal easing yet to peak (which will occur in H1 2019), the US economy is growing well above potential and we see wages and inflation ticking higher in the months ahead.

The next couple of quarter-point hikes already feel well baked into the cake and although the Fed will come off auto-pilot and become more data dependent in 2019, our view on the economic trajectory makes it unlikely that the Fed will want to risk pausing next year, if our views are correct.

Norway deal a sour cherry for 'Leave' supporters?

In the UK, the Labour Party conference left open that door for a 'people's vote' on Brexit. How this may be framed is still unclear and it seems Labour leadership is keen to avoid pushing a 'Remain' agenda lest it alienate 'Leave' supporters in the event that an early election takes place.

Nevertheless, with a large majority of the Labour membership now supporting a reversal of the Brexit decision, we believe that this is the direction of travel.

In particular, when it becomes apparent that a 'Norway' type deal keeping the UK in the single market means that the only change in the UK's relationship to the EU will be the loss of its ability to influence, vote and veto – then a 'No Brexit ' outcome may come more clearly into view.

In this sense, a 'Norway' deal could be seen as a stepping stone to a reversal of Brexit altogether. However, for now this is some way off, and in the short term it appears that an increasing numbers of Tories want to flirt with the hard Brexit scenario, effectively looking over the edge of the cliff.

It may be that the UK needs a collective moment like Greece had in 2015 before it changes its stance, and it seems that EU policy makers share this view as well. This means that Brussels has little incentive to offer concessions to Westminster and the political temperature needs to heat up through October, even as the weather outside grows colder.

EM enjoys a headline respite

The past week was a much quieter one in emerging markets (EM). September has seen a retracement rally in many EM countries, yet we are concerned that fundamentals remain challenged and should US yields start rising again, this could create an additional headwind in weeks to come. Strong demand for new issues broadly supported credit markets on both sides of the Atlantic, but away from peripheral issuers, volatility in credit remains relatively low.

Looking ahead into the fourth quarter, as and when Italian volatility subsides and EM headlines abate, then we see the focus of markets could come back more on economic activity data. Notwithstanding headlines and worries related to trade, we would not be surprised to see PMI surveys remain in upbeat territory, labour market data robust and some upside risk to core prices and wages. If the global backdrop is constructive for risk assets, then core yields may likely drift higher in the coming quarter – yet should this move occur too rapidly then a risk-off flight to quality could easily manifest. In this context, treading carefully remains the order of the day.

As for Italy, we hope that policy makers can be trusted to understand what they are doing. It has always seemed that they would want to engineer the biggest possible fiscal giveaway they thought financial markets would let them get away with and time will tell whether they have calibrated this correctly or whether they are just taking the pizz(a).

Global Asset Management

RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **us.rbcgam.com**