Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Investment Grade Debt Update

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It's Rocking in the US

10-year US Treasury yields have justifiably hit multi-year highs amid a booming domestic economy. Elsewhere, Italy remains a focus where we believe fears of an Italexit are overblown.

US boom time

US yields broke higher during the past week, thanks to further strong economic data and perceived hawkish comments from Federal Reserve (Fed) chair Powell. Yet, it strikes us that little has fundamentally changed.

The US economy has been performing strongly for several months (the Atlanta Fed Nowcast of GDP has been running consistently above 4% since May). A Fed narrative that further rate hikes are expected on a gradual path and that this is likely to lead monetary policy to turn more restrictive into 2020; have been pretty plain for all to see in the FOMC projections in recent months.

What is notable to us, however, is how resilient US asset markets have been with respect to risk-off sentiment in global markets - coming from emerging markets (EM) some weeks ago and in Italy and European assets more recently - and this suggests to us that the move towards higher yields is well supported and may have further to run.

From a technical perspective, we would also note that demand for longer dated fixed income was supported in Q3 by flows from US corporate pension funds ahead of tax changes, but these flows may abate in Q4, just as Treasury supply picks up. In light of this, we had moved slightly short US rates in the second half of September and added to this position at the start of this week, though, for now, express only a modest conviction on this view.

Rates risk seems more symmetric than in prior moves higher and we are concerned that if yields rise too quickly too soon, this could lead to a risk reversal and a flight back to quality. In this context, 10-year US yields above 3.3% may not be a problem, but a near-term test of 3.5% could be more worrying and wage and inflation data could provide a catalyst.

All eyes on BTPs

Elsewhere, Italy has continued to dominate the headlines, with Italian government bonds (BTPs) under further heavy selling pressure at the start of the week on concerns related to the 2019 budget, before recovering somewhat as the week has progressed. As budget details emerge, targets for the deficit in 2020 and 2021 have been revised lower and markets have been somewhat reassured by a more conciliatory tone towards Brussels coming from Rome. We continue to see Italexit risk as extremely unlikely and materially over-priced and although we may expect rating downgrades at the end of the month to low BBB, we believe that it is very unlikely that Italy's investment grade rating will be challenged.

Indeed, recent economic data in Italy have surprised to the upside and we would note that the growth estimate used in Budget numbers are supplied independently by the Ministry of Finance and they have recently been further inclined to take a more optimistic view having historically maintained a more negative assessment on Italian growth prospects. During the weakness in BTPs, we have maintained and added to risk that we hold in Italy and we believe that market commentators are much too bearish.

We believe that many are being myopic in their analysis of a few tenths of percentage points with respect to the Italian budget deficit and ultimately growth will be the biggest determinant in the next few years as to whether debt/GDP levels rise or fall. We remain relatively constructive on the Italian domestic economic outlook and in the past week unemployment has fallen to a 6 year low of 9.7% and the 5G telecoms licence auction concluded with bids totalling EUR6.5bn, which was double what was expected. Incidentally, this sum is equivalent to nearly 0.4% of GDP and can be viewed as an underlying indicator of business confidence in the economy at a time when the European economy is broadly moving in the right direction.

Path to chaos

In the UK it has been the turn of the Conservative Party to hold their annual conference. Following the Boris Johnson 'chuck Chequers' speech we continue to see PM May caught between a rock and a hard place in terms of trying to marshal a deal that her Party would be prepared to fall behind – let alone one which Brussels will agree to.

Notwithstanding rumours of progress being made in Brexit talks we believe that the UK is going nowhere in a hurry and compromise is looking increasingly unlikely. A situation of a hard Brexit (Canada style) or no Brexit looms in our minds – and the more we dwell on the former, the more we conclude that it is a path to chaos which will make the latter more likely now that Labour is prepared to support a 2nd referendum.

A strong greenback

Corporate bond spreads followed moves in equities over the week. In Europe, Italian weakness has pushed spreads in peripheral names wider, though on the whole, credit has been relatively well behaved. EM was also continuing to rally until US Treasury yields pushed higher with the dollar moving stronger. We believe that a number of EM countries remain exposed to headwinds from higher US rates and we retain a cautious stance.

In FX, the past week has seen some generic dollar strength and we remain inclined to look for a strong greenback going forward. We feel a view versus Chinese renminbi makes the most sense as this trades as a dollar basket, but also offers a seemingly asymmetric opportunity coming from CNH weakness related to a softer Chinese outlook. The conclusion of USMCA talks last weekend is unlikely to signal a more lenient stance on trade in our view and further China tariffs remain likely, which could persuade Beijing that it needs to ease policy and allow the currency to weaken a little to offset the effects of these tariffs.

Past peak globalisation

Looking forward we highlight that the US economy will drive the Fed who will subsequently drive rates going into 2019. This seems a rather simple statement to make – yet it seems that in recent months investors have started to pay less and less attention to economic data and perhaps it is time for a renewed focus – particularly with yields breaking up out of existing trading ranges. Within payrolls today we will be particularly interested to see any signs of wages picking up and it has been interesting anecdotally to see that Amazon this week has raised its minimum wage to USD15 per hour.

The US economy looks like it is continuing to boom from where we sit and we won't be surprised to see evidence that the Phillips curve is re-exerting itself. In particular, we would note that global trends towards political populism have at their heart a frustration at the stagnation of median incomes in the past decade and looking forward we would expect the GDP share to capital to start to fall and the share towards labour to begin to rise. These trends may infer more inflation and lower corporate earnings growth, yet it seems clear that we are well past peak globalisation and free trade and the tide is unlikely to turn for a long time to come.

The US is booming – yet quite why Theresa May is busting out with the robotic dance moves is anyone's guess!

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