Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Investment Grade Debt Update

October 12, 2018

Get Shredded

At a time when markets have shredded investors' returns on the year, with most all indices across asset classes in negative territory, this is still time to be on the front foot.

Global equity markets have fallen around 5% in the past week as higher yields and trade worries, met stretched valuations in markets suffering from a loss of breadth and momentum, meaning that technical signals moved into sell territory.

Volatility has jumped above 20 on the VIX (CBOE Volatility Index) and it is notable that a number of European and Asian indices are now nursing double-digit losses for 2018, though broadly speaking the move in stocks did not feel as panicky as we witnessed at the start of February.

Populism's impact

Flight to quality saw yields fall, but the rally only took Treasuries back to levels before last week's US payrolls report, which confirmed further momentum in earnings, with wages growing at a rate above 4% annualised based on the past three months of data.

Ultimately, we are concerned that populism as a political trend will tie in with policies that will tend to favour labour over capital in quarters to come - and indeed we see the fall in the share allocated to labour within GDP and a stagnation in median incomes as key factors driving these political trends in the first place. This may mean it becomes more challenging for corporate earnings to grow as quickly as they have, even in a climate of robust growth and if longer dated bond yields rise in line with our medium terms views, then the higher discount rate this infers on equity valuations will also create a headwind for stock markets.

This said, in our view, any rise in yields is likely to be relatively gradual for now. Policy remains accommodative and although we expect inflation to rise slowly, it currently remains benign. This would suggest that it may be wrong to become too bearish on stocks at this point at a time when the US economy is particularly strong and the rest of the global economy remains in a broadly healthy position. Looking forward, we feel that equity investors may need to get more used to range trading markets, while in fixed income we feel that should flight to quality see yields drop too far in the short term, this may create opportunities to add to our existing short duration position.

Brexit and the budget

In Europe, there has been little new news over the past week. Gossip suggested that a growing number of Labour MPs may be prepared to support Theresa May in delivering Brexit, but we remain rather sceptical on this and feel that the rally we have seen in the Pound as a result of this, seems to be misjudged.

Italian politicians have continued to sling mud in the direction of Brussels and this has kept investors nervous, but we would highlight here that there will always be a divergence in politicians comments aimed at their own electorate (especially when they are still de facto in campaign mode) and what they really believe and will deliver in practice.

In assessing the situation in Italy, we have recently found ourselves asked for what our plans might be in order to set Europe on a more sustainable path, given our view that euro break-up fears are currently over-priced. Although wary of turning a weekly commentary into a lengthier piece, a few personal thoughts on this are shared in a couple of following paragraphs (feel free to skip the section in italics if you want to avoid the rant!):

Under Eurozone rules, governments are required to maintain their fiscal deficit below 3% of GDP. Countries with debt levels >60% of GDP are also required to manage policy such that debt levels decline towards this level over the medium term. These rules – with the threat of sanction in the context of Excessive Deficit Procedures can be viewed as a metaphoric 'stick' in order to preserve discipline and the integrity of the Eurozone. However, it could be argued that this 'stick' will be more effective if there is also a 'carrot' to incentivise countries to stick to this discipline – notably countries in the eurozone such as Italy, which maintain elevated levels of government debt.

One suggestion would be to for the European Stability Mechanism (ESM) (or another entity) to offer debt guarantees on outstanding debt with less than three years to maturity, subject to 3-year fiscal plans meeting tests which could be applied to fiscal performance. Such a step could materially lower borrowing costs –delivering a material fiscal benefit to those countries which need it the most. For example, it could be argued that in such a situation, Italian borrowing costs could be approximately flat to swaps (which would represent a 100bp reduction in rates compared to where they stand in October 2018).

As Italy has gross funding needs of around 15% of GDP, such a saving would materially benefit the fiscal position, creating room for easier fiscal policy, a stimulus to growth and further progress in debt/GDP ratio reduction.

Although such a guarantee could just be applied to newly issued securities <3 years to maturity, this issuance would likely pull yields down across the curve as it would:

1. *Serve to demonstrate solidarity within the eurozone and mutual support within a robust rules-based framework*
2. *Act as an incentive towards responsible policy making (a problem today is that in the case of a large country like Italy, a game theory situation exists in which the country knows that it has the ability to bring the whole of the eurozone crashing down, if it itself crashed out of the single currency – and so there is insufficient incentive to act responsibly).*
3. *Reduce borrowing costs for other debt issues by helping to reduce country risk, without creating a two-tier bond market of senior and subordinated bonds (the old Breugel Institute Red bond and Blue bond idea)*
4. *Over time all short-dated bonds would become government guaranteed. The way the forward curves work in bond markets, the fact that the whole of the 3 year part of the curve would trade no wider than swaps – would mean in turn this limits the spread at the 5, 7 and 10 year points further out the curve*

Such a plan would need to set limits on the maximum percentage of the outstanding debt stock that could be financed in these new securities so that Debt Management Agencies don't try to game the system by issuing lots of short-dated debt. It would need to be administered objectively and indeed the ESM could be expanded/empowered to preside on the tests which need to be passed in order to ensure that guarantees are given.

Additionally, it would be noted that once countries start 'taking the carrot', then they won't find it easy to give this up voluntarily. It is hoped that this locks countries into adherence to the fiscal framework and over time, there is no reason that debt mutualisation could not go another step further – by extending guarantees out to longer-dated securities.

Although there may be some protest at debt mutualisation from Northern European countries – it can be argued that eventually, either the eurozone can grow closer together –or it will risk coming apart.

Higher borrowing costs are a tax on the periphery at the expense of the core and serve to lower growth in these countries ensuring the gap between countries such as Germany and others only grows over time. Germany has done very well out of EMU. It can continue to do so but needs to be prepared to support others along the way and a plan such as that outlined above would seem like a smart way of actually embedding the rules-based discipline, which Berlin would love to see.

Engaging with volatility

As we look forward, we believe that volatility may remain elevated through the end of the year. The move higher in US rates creates an opportunity but also presents risks. We believe that emerging markets could see renewed volatility and we retain a cautious stance, favouring views on a relative market basis.

The weakness in Italy and Greece has created very interesting valuations in our estimation, with Italy CDS 50bps wider relative to Brazil and close to flat versus the iTraxx Crossover credit index of high yield corporate bonds. Brexit is moving towards its endgame and with equity volatility also rising, it feels like there is much to play for in the next couple of months.

Successful navigation of this period may offer far more return opportunity than we have seen during the first three quarters of 2018, but this will require insights through analysis, the ability to take contrarian positions and occasionally the ability to retain risk in markets moving against positions.

At a time when markets have shredded investors' returns on the year with most all indices across asset classes in negative territory, this is still the time to be on the front foot. It is not a moment to stare in open-mouthed disbelief, Banksy style...

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