

# Portfolio Manager Perspectives BlueBay Investment Grade Debt Update

October 19, 2018



## Brexit Hope or Up in Smoke?

The UK is veering towards a point in which it will need to look over the cliff edge of a hard Brexit, before relenting – likely triggering a general election.

Global bond yields moved slightly lower over the past week. With the monthly US data calendar being front-loaded, it seems that there is a limited impetus to drive yields for the time being, with the Federal Reserve (Fed) largely on autopilot and the growth backdrop remaining strong without any clear evidence of overheating at this point.

A recovery in equity markets created more favourable conditions for corporate bonds, while emerging markets continue to make up ground as sentiment turned more constructive following on from last weeks' release of Pastor Andrew Brunson by the Turkish authorities, which led to hopes for improved US relations. Spreads in the European periphery were under pressure with little new news to go on, but investors continue to wait for Moody's rating action on Italy with a downgrade to Baa3 widely expected at the end of the month.

### Brexit Defeat

Newsflow in the UK continues to be dominated by Brexit headlines. Early hopes for a compromise deal for the transitional period between

the UK and the EU were scuppered with Theresa May realising that her need to compromise towards the Brussels position, meant that she was risking losing the support of her own party.

Prospectively, it can be seen how a deal could be struck which effectively keeps the UK within the single market until 2020 in a relationship similar to that which Norway has today. In this context, the only thing which would change in March 2019 would be the UK's ability to influence the European agenda and this could potentially put it in a weakened position to negotiate its future trading relationship with the EU, so it is easy to see the shortcomings of such a plan from the Brexiteers point of view.

However, as the alternative to this is a hard Brexit, which sees the UK leaving without any deal at all, there is a sense in which the debate becomes one between the lesser of two evils. In this light, we continue to see the UK veering towards a point in which it will need to look over the cliff edge of a hard Brexit, before relenting – and at this moment we continue to attach a relatively high probability that this could trigger

a general election. For this reason, it would be churlish for Theresa May to hold out too much hope for rebel Labour MPs to back her and consequently there is a sense that something will have to give.

It is clear that this will have to happen within the UK as the rest of the EU is under no real pressure to compromise much further, in the knowledge that many on the continent continue to hope that Brexit will be cancelled with a 2nd referendum becoming necessary.

### Labour in the Wings

We believe that a general election is more likely than a second referendum. We suspect that in such an eventuality, Labour will call on voters to scrap the 'Tory Brexit'. We might imagine a Corbyn government being given an extended period to re-examine Brexit with Article 50 on hold and once it becomes clear that the only way to stay in the Single Market and preserve jobs is to pursue a Norway type outcome. Then the loss of influence this infers for a large country like the UK, which is used to being able to wield such influence, may mean that Brexit eventually gets shelved.

Indeed, were a Labour government to come to power supported by the SNP, such an outcome would become even more likely. Clearly, at the moment, such scenarios are relatively far off speculation, yet it has been clear with the clock ticking down for some while, that much will be decided in terms of the UK's future around the end of this year.

### Mid-terms and Marijuana

Looking forward, lower volatility may help risk assets deliver better returns in the 2nd half of the month than at the start of October. In the US, attention will soon be switching to mid-term elections and our further thoughts on the outcome and implications of that vote will focus in upcoming weekly updates. For now, we are hoping that markets in the European periphery can stabilise to a degree.

As for the Brexiteers – one wonders whether their dreams of a Canada Plus type of relationship with the UK offer any real hope, or whether, as we might think - they are simply smoking dope. After all, that seems a pretty appropriate way to put it, in the week which has seen Canada legalise marijuana!

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