Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Investment Grade Debt Update

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Happy November?

It seems that many investors will have been happy to see the back of October, with global equity markets down between 5-10% on the month amidst some volatile and erratic trading conditions.

Position stop-outs have been a theme across markets in recent weeks, with investors being forced to de-risk, but as we start a new month there are reasons to be hopeful that this move has now largely run its course for the time being.

Steps to ease policy in China have helped to reassure those worrying that the economy is slowing too rapidly, and with much of Europe's weak third-quarter GDP disappointments linked to a more temporary slowing from the auto sector, there are reasons to look for a better outturn in the fourth quarter.

Elsewhere, US data has proven robust and, surveying the corporate earnings season, the picture remains broadly upbeat – even if the passing sugar rush from lower corporate taxes means the pace of earnings growth is likely to return to a more moderate speed in the next few quarters.

It's all about growth

Looking at eurozone economic data in more detail, a disappointing 0.0% quarter in Italian GDP renewed concerns over debt sustainability in light of the recent budget plans. However, we are more inclined to see this as part of a disappointing third-quarter +0.2% print across the eurozone, rather than anything specific to Italy.

We are somewhat more hopeful that Italian growth should be more robust in the fourth quarter, with more recent October data for retail sales (+0.7% mom), industrial sales (+1.2% mom) and production (+1.7% mom) all well ahead of expectations.

Nevertheless, growth remains key to the overall debt trajectory. In our own models, we require annual growth of 1.0% combined with 1.5% inflation in order for debt/GDP to decline, given current funding costs and a realised fiscal outcome which is 0.5% worse each year than the stated government budget plan.

Elsewhere, we have seen S&P join Fitch in affirming mid-BBB ratings for Italy, though adjusting the outlook to negative. In the absence of rhetoric suggesting renewed interest in an Italexit from the single currency (which we believe remains very unlikely), we see a shortfall in growth as the biggest risk to Italian credit ratings in 2019, noting with interest that S&P already assume a 2.6% deficit for 2019 within its own rating assessment.

More generally, we feel that the weak third-quarter growth number in the eurozone may require the ECB to cut its growth forecasts at the December meeting, and this would make the announcement of a QE twist and / or a new LTRO a rising likelihood, in our view.

The ECB remains far from a point where it will think about raising rates and this is likely to keep Bund yields anchored, even at a time where we feel that US yields can start to drift higher again, with US data remaining robust and flight-to-quality flows abating.

Political influence

The news that Angela Merkel will step down as CDU head in 2021 did not come as a big surprise and political attention is now switching to the US mid-terms. Markets seem sanguine given the view that Trump has already advanced most of the agenda he wanted to deliver, with the second half of his presidency more likely to focus on gearing up for the next presidential election.

Brexit news was relatively sparse over the week with the clock still ticking down. Our meetings with European policy makers this week suggested that a November summit was a possibility, but reaffirmed that May could expect few concessions from the EU, leaving her in a difficult place with respect to selling a deal to her own party.

With Brexit dominating thinking, this week's Budget passed by with hardly any attention in markets and, while we play the waiting game, there is a sense that everything will come to a head in a few weeks.

GE exception to the credit norm

Corporate credit has continued to trade with equities over recent days, with spreads slowly recovering over the course of the past week. A notable exception to this trend was GE, which suffered from further spread widening after Moody's cut its credit rating to Baa1 on concerns regarding leverage trends, litigation risk and worries related to the power business.

Elsewhere, emerging market performance was relatively mixed. Mexican assets have been under pressure following the cancellation of the contract to build a new airport in Mexico City by the AMLO administration. Following hopes that the new government would adhere to a more orthodox programme having taken office, populist worries have come to the fore once again – highlighting yet again how politics and policy can have a substantial bearing on financial markets

The China call

We remain constructive on US growth and are hopeful that European growth should rebound after a weak third quarter. We have had a more bearish view with respect to China, but as this thinking becomes more mainstream, we note that domestic policy makers are taking steps to support growth and this should limit further downside for the time being. Domestic consumption remains robust in China – even if consumers seem to be veering away from imported goods. The property market also appears healthy – even if leverage concerns have seen companies like Evergrande and Kaisa under severe pressure, raising US dollar debt at double-digit yields.

Getting the China call right remains highly important to the overall macro view. In hindsight, it seems that China has been slowing for the past six months – even before tariffs were introduced. As policy makers react to this, the next month or two could see a short-term bounce in sentiment – even if this remains up for debate and the longer-term outlook seems more clouded.

We expect next week's Federal Reserve (Fed) meeting to pass without much excitement. Notwithstanding Fed bashing from Trump in recent weeks, we expect Powell to be largely immune to this criticism. It seems obvious, in our view, that Trump wants to take credit when stock markets go up and uses the Fed as a convenient scapegoat when equity prices go down.

The Fed, for the sake of its credibility, needs to demonstrate that it is above this political noise. We continue to expect quarterly rate hikes in coming quarters from the FOMC and believe those commentators calling for the US economy to reach the end of its economic cycle to remain frustrated.

October has been a month when the doom-mongers have been in the ascendency, but with the arrival of November we are cautiously hopeful for happier days ahead.

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