Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Investment Grade Debt Update

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Credit Goes Cold Turkey

Poor technicals have jolted credit markets recently, but a deeper bear market in credit should only manifest in the next global economic downturn.

Financial markets endured another volatile week with credit spreads under pressure as equities posted further losses, led by the tech sector. Worries that corporate bond supply is continuing to outpace demand has been a source of investor concern for the last few months.

Spread decompression

Consequently, price action has been weak, with spreads decompressing as higher yielding securities were exposed to the worst of the price action. A partial rally into Thanksgiving has helped in the short-term, yet spreads remain wider with sentiment turning more risk-averse.

Looking forward, we would continue to assert that credit fundamentals should be supported by our constructive economic outlook - notably in the US - with corporate earnings to remain robust and default rates set to stay at low levels. Ultimately, a deeper bear market in credit spreads should manifest in the next global economic downturn but this is not something we are predicting in the near term. Nevertheless, market technicals may not improve much anytime soon and there may need to be more examples like GE, of equity prices being punished in the face of credit market weakness or balance sheet leverage concerns, for debt financed stock buybacks to abate and for corporate bond supply to slow down.

In this context, we have been reducing exposure in corporate credit in recent months. However, this weakness has negatively impacted performance given that our preference in European credit has been the higher yielding sub-sectors such as corporate hybrids and subordinated financials which have not been part of the ECB bond buying programme.

No path to Italexit

Spreads in the periphery were also under pressure again in recent days over worries related to investor appetite for new Italian debt issuance. However, these moves were retraced later in the week and markets in the periphery remain choppy and volatile with spreads having moved a long way since the announcement of the Italian budget at the end of September.

We continue to affirm our constructive medium-term view as we see Italexit risks as overstated and worries related to credit rating downgrades and debt sustainability concerns as overplayed. In the short-term we expect Italy to be placed into Excessive Deficit Procedure (EDP) by the EU but note that many sovereigns in Europe have suffered the same treatment in recent years. We doubt fines will ever be imposed, with such sanction not utilised in the past even in the face of serial offenders to the EU fiscal criteria (France, for example, has breached a budget deficit of 3% of GDP on 10 occasions in the past 11 years).

Edge of the cliff

In the UK, Theresa May has clung on to power for the time being, but little new information has surfaced, and we still expect sterling to come under pressure with the government likely to lose the vote in Parliament on their Brexit deal at the start of December. Indeed, May might hope for a sense of crisis following such an outcome as this may see MPs return to the fold and agree her plan on a second hearing. However, we subscribe just as much of a chance that her party will seek to depose her at this point. In this case, the UK may need to stare over the edge of the cliff which a no-deal Brexit could infer - and only at such a point do we then see a 2nd Brexit referendum or a general election as a more material probability.

Yield upside

This leaves us positioned with a very negative view of the pound in the short-term, but also a negative medium-term view on UK Gilts. If May's plan succeeds, or if Brexit is overturned, or indeed if a Labour Government were to come to power, we see yields in the UK materially higher. Meanwhile, although a hard Brexit could see yields decline on a flight to quality, this pricing would be fleeting in our view. Ultimately, a sterling crisis could lead investors to exit all UK assets and with the UK running fiscal and current account deficits and with the government in this scenario likely to need to enact substantial fiscal easing, we don't see Gilt yields staying down for very long.

Slowing China

Elsewhere, China growth concerns continue to fester and weigh on sentiment towards global growth. We expect China to continue to slow as it has in the past seven months - yet with Beijing starting to ease policy in the past several weeks we believe it may not be the right time to turn much more bearish. We see the US economy as largely insulated from China slowdown worries, but Europe is more exposed - particularly if more populist rhetoric encourages Chinese businesses and consumers to buy more goods and services manufactured at home.

Not much to give thanks

Looking ahead, Christmas isn't far around the corner and it won't be surprising if many investors feel they don't have much to celebrate this Thanksgiving Day. 2018 has been a bit of a turkey, but hopefully it will end on a sweeter note.

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