Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Investment Grade Debt Update

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Don't Lose Your Bottle Under Pressure!

Investors have had their bottle tested in 2018, but if a major fight at the G20 can be avoided, we remain hopeful that the year can end on a more cheerful note.

A more dovish tone from the Federal Reserve's (Fed) Jerome Powell helped risk assets to bounce during the past week, with equity markets little changed heading towards the end of the month. Government bond yields moved lower on comments that US rates are 'not far from neutral', but we believe that it is wrong to conclude that Powell will throw in the towel when it comes to raising rates in 2019.

Autopilot to data-dependent

In our view, US growth is set to remain well above trend in the months to come, powered by the US consumer whose disposable incomes are rising rapidly thanks to a combination of higher wages, jobs growth and lower taxes. Housing activity has cooled a bit in the past few months yet remains relatively healthy and headline inflation has declined with oil prices moving lower. However, in our view, it would be wrong to conclude that this economic cycle will die of old age and we still see financial conditions as broadly accommodative.

To be clear, we see the Fed in 2019 becoming much more data dependent with monetary policy moving off the autopilot stance it has been on during the past few years. But we fully anticipate strong data to lead to three or four rate hikes over the course of 2019 and so retain conviction with respect to a short US duration position via Eurodollar contracts, where a total of only 20bps of monetary tightening is now built into market pricing for 2019 and 2020.

Bad technicals

Whereas perceptions of a 'Trump put' have helped to lift equity prices, price action in corporate bonds has continued to be more subdued, given ongoing worries of supply outstripping demand. We don't see the technical backdrop in credit markets improving much any time soon. However, we would assert that fundamental factors will dominate prices in the end, and ultimately fears of a much deeper sell-off in credit spreads will be contained in the absence of rising defaults – something we aren't projecting in the year ahead given our broadly constructive view on the economic cycle.

LTRO and Twist

Meanwhile, in the eurozone, comments from central bankers Peter Praet and Mario Draghi continue to suggest that European Central Bank (ECB) thinking has changed little during the past several months. Notwithstanding this, we believe that the central bank will need to adjust its 2019 and 2020 forecasts materially lower at its upcoming December meeting. This may necessitate additional measures to support monetary accommodation, particularly as we think it's very unlikely that the ECB will want to cancel its plans to stop additional QE purchases of bonds at the end of this year.

This means an extension to the long-term refinancing operation (LTRO) and a 'Twist' operation both become likely and if these aren't announced in December, then they may become likely in the first quarter of the coming year unless economic growth picks up in the months ahead.

Confrontation to pragmatism

Signals coming from the Italian government that it may be prepared to delay the implementation of fiscal easing measures to lower the projected 2019 fiscal deficit saw the periphery trade better in the past week, on the hope that we could be moving away from a period of a Rome/Brussels confrontation and towards a period of pragmatism and compromise.

It is tempting to believe that, at its heart, the administration in Rome really wants to boost GDP growth in Italy in the year ahead and is becoming aware that rising Italian credit spreads risk achieving the opposite result. Indeed, with Unicredit Spa raising senior non-preferred debt this week at an eye-watering spread of 494bps over US Treasuries, for what we consider to be a bank with very solid fundamentals, one can see the potential damage which can be done when banks need to pass such elevated borrowing costs on to domestic borrowers.

National crisis

In the UK, the Brexit clock continues to tick down, and we feel pretty sure that Theresa May's vote on her deal will fail by a large margin when it goes before Parliament on 11 December. We continue to believe this will see fears for a hard Brexit rise and with the Bank of England making catastrophic projections for the UK economy and the Pound in this outcome, we believe markets remain too complacent with respect to downside risks related to the currency.

Ultimately, we continue to feel that another referendum or a general election may become likely, but the path to this will only occur if there is a much greater sense of national crisis in the meantime. Consequently, we retain a strong conviction view short on the Pound versus both the euro and the US dollar.

G20 preview

In the run-up to G20 this weekend there has been some hope that this summit could end on a more amicable note, though we continue to hold the view that there are limited prospects for a change of course from the US administration when it comes to the eventual imposition of tariffs on all Chinese imports.

Ultimately there is a populist desire to boost jobs and wages within the US and, furthermore, a desire to limit and contain the rise of the Chinese superpower. This can potentially make for an uncertain geopolitical landscape – even if we would acknowledge that, at this point, Donald Trump is still on track for being the first US president since Jimmy Carter not to have fought a (physical) war while he has been in office.

Meanwhile, in a week when GM has announced job cuts and plant closures which have impacted the rust belt, it is interesting to follow Tweets suggesting that auto tariffs on Europe could be the next target of Trump's trade offensive. In time, we wouldn't be surprised to see the US exit from WTO in the months ahead, leading to the end of this institution, as de-globalisation trends continue to run their course in months and quarters to come.

Tested like Mourinho

Nevertheless, if a major fight at G20 can be avoided, we remain hopeful that the year can end on a more cheerful note compared to much of what we have seen in recent months. Like football manager Jose Mourinho, investors have had their bottle tested in 2018, yet we feel that it would be wrong to become too bearish on the global outlook at this juncture. With events like Brexit needing to be resolved before the year is done, we think there will be opportunities to score performance right up until the final whistle, yet the outlook for the global economy should still be relatively constructive in the year ahead, regardless of what the UK decides to do.

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