Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Investment Grade Debt Update

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Don't Let the Grinch Steal Christmas

Risk-off sentiment has returned to markets with a vengeance, but we feel that this is not a moment to capitulate on a constructive view on the US economy.

After starting the week with an optimistic tone on hopes for a trade truce between the US and China following the G20 summit, risk-off sentiment has subsequently returned to markets with a vengeance, as investors appear to grow increasingly concerned with respect to the investment outlook heading into 2019.

Tilted to the downside

Worries related to slowing global growth are linked to fears that the Chinese economic outlook is continuing to deteriorate, notwithstanding recent policy easing in Beijing. Yet for now, China PMIs remain above 50 (expansionary levels) and other barometers of economic activity such as the Li Keqiang index remain at levels consistent with an economy which remains healthy – even if it is growing at a slower pace than has been witnessed in past years.

However, markets are clearly worried that the risks in China are tilted to the downside and news of the US driven arrest of the Huawei CFO (who is the daughter of the Chinese telecom giant's founder), clearly plays on this paranoia and fears that the 90-day extension on trade talks will only prove a temporary and fragile ceasefire.

With China the world's second largest economy and the biggest contributor to growth in global GDP, what happens in China is hugely significant and it seems that Beijing is caught in a bit of a trap trying to reduce domestic leverage at the same time as ensuring robust economic growth. In addition, we are inclined to believe that the US desire to limit the rise of China will mean that tariff extensions may be inevitable, and that Beijing will need to ease policy further in the months ahead.

The mighty US consumer

Notwithstanding this rather downbeat China view, we would continue to assert that this, in itself, does not need to be bad news for the US economy. US economic activity remains robust, as demonstrated by further strong ISM surveys this week and we expect payrolls today to confirm further growth in employment and wages.

With the US economy being led by the consumer and with personal tax cuts also boosting disposable incomes at the start of the coming year, we believe that the mighty US consumer can power above trend growth in the year ahead and so fears that an economic slowdown is on the horizon seem very misplaced to us.

Curve flattening

The flattening of the US yield curve has seen 2-5s invert during the past week and many quant models will take this as a recessionary indicator. We would be dismissive of these signals from the yield curve and believe that term premia are distorted by low yields elsewhere in global markets coupled with a desire among pension fund investors to match longer-dated liabilities with longer-dated assets. Consequently, the rally in rates, which has likely been exacerbated by quant driven investors in CTAs, means that market pricing (which discounts no further Fed hikes after this month) is now much too complacent on the Fed in our view and we are inclined to increase conviction in this position.

Policy error

European PMIs, wage and retail sales data have also been somewhat more encouraging in the past week, yet this has not prevented Bund yields sinking to their lows since mid-2016. In part, a bounce in European economic activity has been expected in Q4 after weakness in Q3.

However, unlike the consumer driven US economy, the eurozone is much more dependent on exports for its growth. Given worries related to trade tariffs, Brexit risks and Chinese slowing, it seems that European exporters are facing challenges on multiple fronts. With the ECB set to cut its growth and inflation forecasts for 2019 and 2020, it is starting to look as if the decision to end QE balance sheet expansion at this point could be a policy error, with core inflation well below target and risks skewed to the downside.

We sense that the ECB will be pushed towards delivering an operation twist and a commitment to extend the long-term refinancing operation (LTRO) when it meets next week, and it seems increasingly as if rates may remain on hold well beyond the end of Mario Draghi's tenure. We feel that low cash rates will continue to anchor Bund yields and so we are not tempted to take a short duration stance, even if we think Bunds are approaching over-bought territory.

Elsewhere in the periphery, it seems as if news flow and volatility coming from Italy is quietening down with Rome and Brussels engaging in a somewhat more constructive dialogue, even if the imposition of Excessive Deficit Procedure (EDP) proceedings by Brussels is an inevitability.

Who blinks first?

Otherwise, the focus in Europe has been around the ongoing soap opera in Westminster, with Theresa May likely to lose next week's Brexit vote by around 90 in our view. Thereafter, there is uncertainty as to what will happen next. It is possible that Conservative MPs push to replace her, whilst the Labour Party will call a vote of no confidence in the government, yet both such moves may ultimately lead to nowhere. This may lead Theresa May to plead for changes to her deal, yet we suspect that Brussels will be in no mood to renegotiate. This could leave the clock ticking down and it needs to be understood that notwithstanding political votes in the past week, unless Parliament eventually agrees to the prime minister's plan, or agrees to hold another Referendum or a General Election, then there will be a hard Brexit with no deal by way of default.

Whilst parties in Westminster are waiting to see who blinks first, we expect Brussels to up the ante by triggering hard Brexit contingency planning later this month – and so the political temperature is likely to rise and with it, pressure on the Pound. Longer term, we remain more bearish on Gilts under pretty much every Brexit or no-Brexit scenario, but for now, the focus will be what happens after next Tuesday with the margin of May's likely defeat expected to be closely scrutinised.

'I did it Hua-wei'

Looking forward, we wouldn't be surprised to see this week's market moves quickly reverse – especially as they have been driven in the wake of position capitulation and low liquidity. In thinking Christmas thoughts, it is tempting to think of the Grinch currently sitting in his castle with a big smile on his face as he sings 'I did it Hua-wei' to the Sinatra tune of 'I did it my way'. But we need to remember that in the story, the Grinch gets his come-uppance eventually and Christmas isn't cancelled after all.

So with markets we feel that this is not a moment to capitulate on a constructive view on the US economy, rather a moment to stand firm and add risk. After all, 'You're a monster, Mr. Grinch, your heart's an empty hole, your brain is full of spiders, you have garlic in your soul'.

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