Stay vigilant but carry on

Q3 Outlook

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Head of Credit Strategy, David Riley, on the recent market rally, lower than expected inflation, the direction of interest rates and what investors should watch out for heading into the second half of this year.

Valuations in core fixed income and equity are near all-time highs, can markets continue to rally?

We think that the overall macroeconomic backdrop for risk assets is positive, but now, more than ever, investors need to be selective and disciplined.

The fundamentals underpinning the rally in risk assets remain in place: faster global growth, rising corporate earnings, falling default rates and central banks maintaining accommodative monetary policies.

However, global growth may have peaked and market volatility is more likely to pick-up than stay at the very low levels experienced over recent months. Interest rates and valuations are at levels that provide little cushion for nasty surprises.

Put simply, don't get lulled by low volatility into not doing your credit homework.

Investors must actively mine the pockets of value that do exist especially in higher yielding credit and emerging markets. But that must also go hand in hand with active risk management so the investments you make today you do not regret tomorrow.

Why is inflation not rising and what does this imply for markets?

A key conundrum facing central banks and investors is subdued inflation. Why isn't inflation rising along with global growth?

We think inflation is currently low due to structural and temporary factors. Technology may be having a bigger disinflationary impact than many realise and factors such as lower commodity prices, past low inflation and inflation expectations will prove to be transitory.

While inflation does seem to have become less sensitive to lower unemployment, we do think that as slack is used up, inflation will drift higher. Whatever the reasons, transitory or structural, lower than expected inflation has acted as an anchor for longer-end US Treasury yields even as the Federal Reserve (Fed) has been raising short-term interest rates. This is why the US Treasury curve has bear flattened recently and in our view, is not a market signal of rising recession risks in the US or globally.

Low nominal and real Treasury yields will continue to be positive for emerging market currencies and credit in particular even if the Fed, as we expect, hikes rates once more this year.

Have you changed your view on the outlook for US interest rates?

One of our core investment themes at the start of the year was that we had passed the lows in interest rates. We still think that duration is a key risk that investors need to actively manage in their portfolios.

In the case of US interest rates, at the start of the year, we expected at least three rate hikes by the Fed in 2017 – starting in March which was certainly not the consensus at the time. The Fed raised rates again in June and we think that it will raise rates once more this year – probably after it announces a gradual shrinking of its balance sheet in September. Our own analysis suggests decline in the balance sheet is sufficiently gradual that it will not prevent a further three rate hikes in 2018. Yet the market is currently pricing just one or two more Fed rate hikes between now and the end of 2018. We retain conviction in our US rates view, but the next test of our and the market's view is unlikely to come until later this year.

How are these views reflected in your (BlueBay) multi-asset credit and other strategies?

We have increased our exposure to emerging market debt, especially local currency sovereign and corporate bonds across several of our multi-asset strategies.

We believe that European bank contingent convertible bonds, also known as cocos, continue to offer attractive risk-adjusted returns relative to other high yielding assets. That said the collapse in the value of Banco Popular cocos underscored the importance of credit selection and risk management that is at the core our investment approach to this asset class.

More broadly, we are over-weight sovereign and corporate credit risk, including the European periphery reflecting the positive economic and political trends across the region – with the notable exception of the UK.

We have retained our bias to be short US interest rate risk (duration) but express that in terms of short-term US interest rates rather than in 10-year Treasury bonds that are also subject to global influences as well as the actions of the Fed.

What should investors watch out for over the coming months?

In our view, investors should focus on Beijing, Washington and Frankfurt – not as holiday destinations, though each have their attractions, but for possible policy shifts that could have meaningful implications for global financial markets over the coming months.

In Washington, Congress rather than the White House is leading the domestic policy agenda. The market may be too premature and complacent in virtually completely discounting any chance of a meaningful fiscal stimulus. If investors begin to price back in some fiscal stimulus for 2018, expect higher US rates and greater dispersion in asset performance.

Looking east, Beijing is engaged in a regulatory crackdown on shadow financing that could lead to a sharper than anticipated reduction in credit and investment growth. Tensions associated with the leadership transition later this year may also spill-over into Chinese markets. China growth scares were key sources of market volatility in 2015 and 2016. Arguable we are over-due a China-related shock to markets.

And finally watch the European Central Bank (ECB) in Frankfurt. There is still is a lot of uncertainty around the timing and shape of the tapering of ECB QE.

We think the third quarter will be characterised by higher volatility than in the second and positive but lower returns on risk assets. Investors should stay vigilant; stay engaged and carry on.