Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Investment Grade Debt Update

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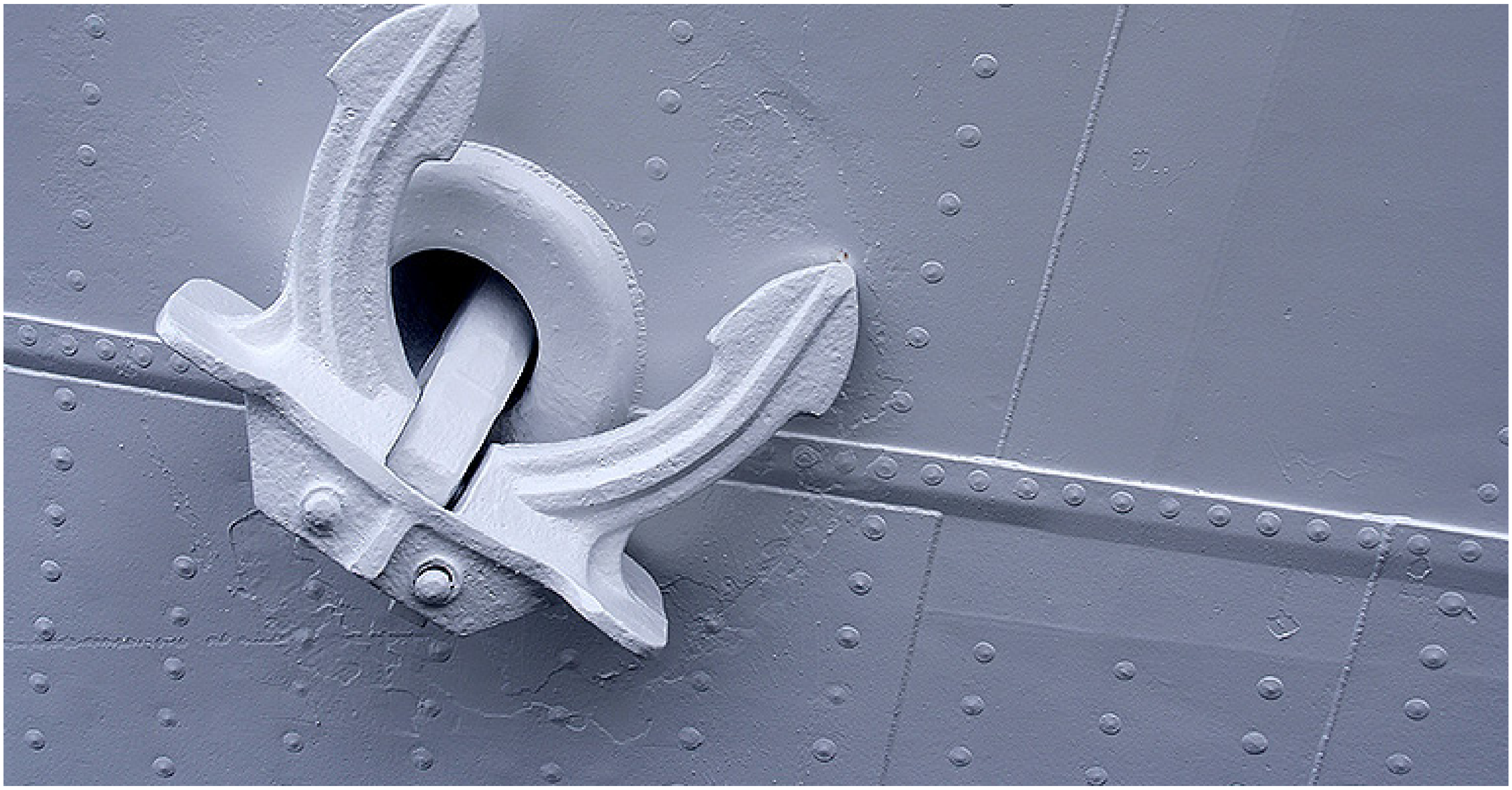

Unanchored Rates the Main Threat

The global economy continues to fire on all cylinders for now but higher rates remain the primary threat to the rally in risk assets.

US yields climbed higher at the start of the past week, as economic bullishness saw equity markets continuing to push higher in a strong start to the year. At a time when even assets launched as a joke, such as Dogecoin, have seen valuations surpass US$2 billion, there is some wonder whether the world is going barking mad. However, strength in the global economy seems broadly undeniable for the moment and at a time when corporate earnings are growing, inflation is subdued and policy remains benign, it is not surprising that get rich schemes are coming to the fore given the growing 'Fear Of Missing Out'. Markets currently discount approximately 2.4 Federal Reserve hikes this year, which remains too little in our opinion and it has been interesting to note of late, that forward inflation breakeven rates have started to rise from very subdued levels. In this context, the recent modest rise in nominal yields has meant that real yields are largely unchanged and for those minded to believe that only a material rise in real yields will lead to monetary policy restraint, then it seems that recent developments in financial markets have done little to restrain economic activity going forward. With the global economy firing on all cylinders, we believe that momentum may be self-reinforcing over the next several months unless bond yields rise, so for the time being, we continue to operate against a backdrop where a long position in risk assets and a short position in interest rate duration continues to be warranted, in our view.

In the eurozone, heavy supply has been matched by demand in the past week with sovereign spreads continuing to trade tighter as investors are eager to get cash to work in assets with a positive yield. Stories suggesting that China is planning to stop investment in US Treasuries appeared very wide of the mark, however, we would observe that Asian investors, in general, seem to have far more appetite for European fixed income than US yields as a function of higher yields in Europe when looked at on a currency hedged basis. Yield curve flattening can be seen weakening demand for longer-dated US assets in a year when the net supply of Treasuries is set to double in 2018 versus 2017 as the Fed shrinks its balance sheet. By contrast, scarcity and ultra-low short rates act as an anchor to European yields and although we expect the ECB to end QE in September and that this makes it hard for yields to rally substantively, these technicals should also help to prevent yields from selling off very far. The European growth and political backdrop appear to be set fair and so sovereign spreads may continue to have room to shrink further as worries with respect to a break-up in the eurozone are increasingly forgotten.

More generally, the backdrop for risk assets remains constructive for the time being. In credit, we are growing a little concerned over the weakening of covenants in the loans market, but broadly speaking credit quality remains well supported due to the macro backdrop. Emerging markets also look set to continue to benefit from the growth backdrop, even though we would warn that trade appears the #1 issue on the Trump agenda right now, and we would largely expect a tweet to announce that the US will serve 6 months' notice with respect to withdrawal from NAFTA anytime soon. This could be negative for Canada and Mexico and we are positioned long in Canadian short-dated bonds (versus the front end of the US) and are positioned short in the Mexican peso from an FX perspective in light of this. Elsewhere in FX, we continue to hold with our preference for Scandinavian currencies and with data in Norway, Sweden and Iceland very strong, we feel short-term technicals which have seen these currencies underperform the euro in the past several months, should soon reverse.

Looking ahead, US consumer price inflation (CPI) later today is one of the most important remaining data releases of the month. We expect inflation to trend up during 2018, but see more of this move from Q2 onwards and consequently a more benign outcome today may be expected. However, we would note that in our view, there remains a lot of complacency with respect to inflation and therefore a surprise to the upside could have a substantial market impact – pushing yields and the US dollar stronger and potentially hurting risk assets. By contrast, a data surprise to the downside should see risk assets move to new highs and this price action of itself will probably constrain the amount that rates can rally. From this point of view, we see a short position in rates as having asymmetric properties and a better expression of our macro thinking, than a directional view on the US dollar, for example.

More generally, we continue to see higher rates as the main threat to the rally in risk assets. Obviously, markets can't continue to rise forever in a straight line, even though one wonders what the market cap of Amazon would reach, if only someone working there were to think of launching an Amazon-coin (with the novelty that you could actually use it to pay for stuff on their website). For now, though, we would rather ignore the waves being made by 'Ripple' and go doggy for a bit of fun (though not in any strategy)!

Who knows where risks may come from in the year ahead? With Kim in Korea wearing lighter coloured suits and making friends in the South, it seems that rhetoric with the US may have peaked out on the 'my button's bigger than yours' playground nonsense seen in the past week. The Middle East is a worry, but may be more of a slow burning story for the time being. Of course, it is always possible that Trump is impeached or Chinese growth stalls or stock markets slump just because a sell-off is overdue and they feel like it. However, there is not much new in this regard and with the year starting in a carefree mood, it may be that something new needs to come along in order to derail price action. For now, not just because it is the middle of winter perhaps, it feels like the right time to be pretty chilled…

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