Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Investment Grade Debt Update

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Frexit and the Fed

Despite gaining traction in polls Le Pen remains a tail-risk while in the US, Fed minutes provide little to ponder.

With French presidential opinion polls suggesting a little momentum swinging towards Marine Le Pen earlier this week, eurozone assets came under a little pressure as a flight to quality bid pushed Bund yields lower. At the front end of the yield curve the 2-year German Schatz contract reached a record low of -0.91%, as fears regarding a possible break-up of the eurozone start to resurface against a backdrop characterised by a shortage of German collateral, at a time when the European Central Bank (ECB) continues to buy far more bonds than the Finanzagentur issues. Since 2012, the idea of a break-up of monetary union has appeared very remote, yet the idea that a populist Le Pen administration could push the eurozone to the brink has seen this notion rekindled. Looking at two on-the-run Italian credit default swaps (CDS) contracts with the same maturity, the 2003 definition contracts (which don't have currency redenomination risk) now trade 40bps below the 2014 definition contracts (which do). By forecasting the likely devaluation of the lira, which might occur were Italy to leave the eurozone at around 30%, we would impute a cumulative probability of around 7% of a eurozone break-up on a 5 year view. This figure remains low, but has trebled in the past two weeks and is something that bears watching carefully as the political backdrop continues to evolve.

Ultimately, were Le Pen to win, we suspect her 'bark' may be worse than her 'bite'. We doubt whether she would have support in Parliament to get much done and would question whether she would ultimately be able to deliver a referendum on 'Frexit'. However, the fear following a Le Pen victory could be enough in itself to expose the weak links in the eurozone and a more populist France may be less than willing to support further bailout programmes, rendering the Outright Monetary Transactions (OMT) somewhat redundant. Moreover, where the ECB has had the mandate to pursue price stability and ensure the proper working of the credit transmission mechanism, it is not in its remit to fix issues, which are intrinsically political by origin. We continue to view a win for Le Pen as a tail risk, and Bayrou's decision to withdraw from the race and back Macron supports this view. But we hold the view that there is more scope for sovereign spreads in the region to widen, rather than tighten in the short term, as it is unlikely that political uncertainty abates in the next few weeks.

Elsewhere in Europe, it appears that Greece is closer to agreeing on a compromise with its creditors and this has seen a solid recovery in Greek government bonds (GGBs) in the past week. We have maintained a relatively sanguine view on Greece – as we also do with regard to political developments in Italy and the Netherlands. In Holland, Geert Wilders may win the most votes in the election but almost certainly won't play any role in the government of the country, whereas in Rome, Renzi's decision to resign as party leader is a tactical gamble to secure a more robust party nomination ahead of the next Italian elections (likely late 2017 or early 2018) and does not change the fact that Italy looks set to be stuck with weak governments for years to come. German politics has also been interesting of late – but with the race between the Christian Democrats and the Socialists getting ever closer it has been encouraging to see support waning from the more extremist AFD party, who are now scoring less than 10% in the latest polls.

In the US, the Federal Reserve (Fed) minutes provided the focal point for bond markets over the past week. The Fed continues to expect multiple rate hikes in 2017 against a solid economic backdrop, but there was little new information in the minutes to suggest an elevated chance of a March rate rise. It strikes us that a March move will require data on inflation and the labour market, which are considerably stronger than consensus expectations and will be focusing on the core Personal Consumption Expenditure (PCE) report on 1 March and the jobs report on 10 March in this respect. We believe that the probability of a March move is now less than 50%, but we remain more hawkish on the Fed than the market currently discounts. We stick to the view that there will be four rate hikes in 2017, on the thinking that the Fed already expected to move three times this year and with global growth looking robust and scope for fiscal easing to contribute in H2, the Fed stands more likely to upgrade rather than downgrade its assessment of the economy, making upward revisions to rates more probable.

As we look ahead, we continue to be struck by the notion that politics and policy will be two key drivers determining market themes in the year ahead. In Europe, we feel that following a period when markets have moved to price in some political risk, there may be something of a lull in proceedings given that the first round of the French election is still two months away. Unless there are large swings in voter intentions or new political developments, it is difficult to see how the market can price in or out any specific outcome at this point and indeed this is highlighted in options markets with a large spike in implied volatility around the date of the 2nd round vote on 7 May.

In the shorter term, Trump's upcoming state of the union type address to the joint session of Congress next Tuesday is likely to provide the next major focus of attention. We continue to await any clarity regarding taxation or spending plans and although we suspect we won't get a clearer picture until the end of March or early April, we may get hints to this in the coming week with Sean Spicer seemingly declaring the 90% of the plans are now 90% agreed. There is also talk of a new immigration bill following the recent humiliation regarding the recent travel ban. It will certainly be interesting to see whether he can reclaim his authority and give the impression that his plan is on track, or whether an unconvincing performance leads to further worry. Notwithstanding this, the US equity market continues to move ahead, reaching new all-time highs on eight out of the last trading days. Indeed it is striking that more than 90 sessions have passed since the S&P last fell by more than 1% in a day (last on 11 October). It can only be hoped that this run does not meet a sticky ending...

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