

Portfolio Manager Perspectives BlueBay Investment Grade Debt Update

February 23, 2018



Rate Risk Now More Symmetrical

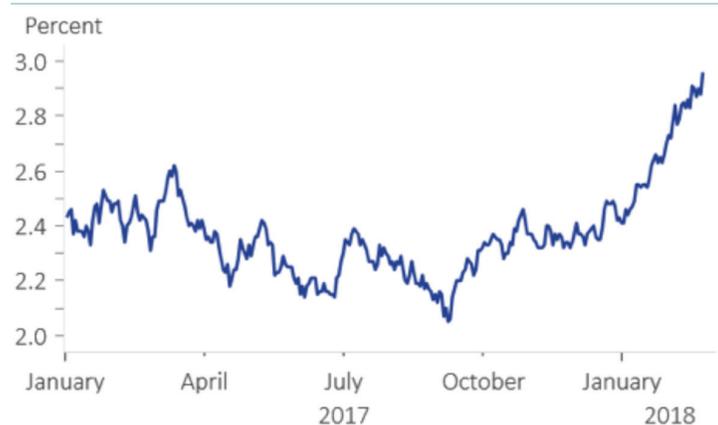
The sell-off in rates means that directional risk is now more balanced and new material information will be required to drive market prices further

Having stabilised following the early February sell-off, market volatility remained elevated in what was a shortened week due to President's day in the US. Despite little new information in the latest Federal Reserve Minutes, US yields continued to nudge higher on fears of waning overseas demand at a time when Treasury supply is increasing meaningfully. Rising hedging costs associated with a flat yield curve appear to be pushing Asian demand towards European fixed income and in recent days, it has been interesting to observe the relative resilience of Bunds in the face of higher Treasury yields. We retain a relatively constructive view on eurozone rates at the current time and are now running overall duration close to flat, with a modest net long position in the eurozone offsetting a reduced short position in US yields.

Broadly speaking, we feel that the sell-off in US fixed income should pause for breath close to current levels with 10-year bond yields close to 3%. With three rate hikes fully priced for 2018, we believe that markets will require new evidence of acceleration in

inflationary pressures in order to start discounting a materially more aggressive Federal Reserve (Fed). With core PCE inflation below target at 1.5%, this may not occur until later in Q2 based on our current analysis. Essentially, market pricing has moved in line with Fed projections over recent weeks and we feel that it may be challenging to push on to a point embedding a view that the Fed is behind the curve at this particular time unless inflation surprises materially to the upside. For now, we continue to see the Powell Fed raising rates on a gradual basis and although we see this hiking cycle extending longer than markets currently expect, it strikes us that in the shorter-term, the forward looking risk profile on rates is more symmetrical in nature than has been for some time. Against this backdrop, running much less directional rate risk makes sense to us, with a view that from current levels we would like to add more Bunds on global fixed income weakness and sell Treasuries should 10-year yields rally back below 2.75%.

Exhibit 1 - United States 10 Year, Yield



As of 2.21.18

Source: Macrobond Financial AB

Sentiment in risk assets remains relatively shaky, with some investors nursing losses from earlier in the month. Nevertheless, we feel that this is a time to focus on fundamentals and look for opportunities amid weakness. In this regard, we have added exposure in Greece over the past week as the sovereign continues to underperform following recent supply. However, credit rating upgrades in the past week by Fitch (from B- to B) and Moody's (Caa2

to Ba3) should make the market accessible to an increased pool of rating constrained investors and with the credit outlook positive, underpinned by a solid fiscal primary surplus, we see scope for further upward migration in ratings over time. Growth and politics in the eurozone continue to trend in a constructive direction and we continue to take a sanguine view with regard to the upcoming Italian government elections.

More generally, we feel that if core rates can consolidate for a time around current levels, then volatility should abate and risk assets should rebound from recent weakness. The macro backdrop remains constructive and as long as the Fed remains on a gradual path and other global central banks pursue a relatively dovish stance, then there should not be too much to drive fear as a dominant force in financial markets.

Looking forward, we look for March to bring more settled conditions in financial markets following a turbulent month in February. Clearly, markets will be sensitive to an upside surprise in inflation data in the days ahead and in this context, the core PCE data next week will be an important release, yet more obvious upside will come in April, at the point when the March 2017 telecom induced inflation drop, falls out of the annual data. Nevertheless, we feel that new material information will be required to drive market prices further and we look for a sense of balance to return. We look for opportunities to continue to add exposure at attractive levels, but as 'worst' Olympian Elizabeth Swaney, demonstrated in the past week – it is always possible to achieve your goals without taking any undue risks, particularly at a time when others are falling over.

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