

# Portfolio Manager Perspectives BlueBay Investment Grade Debt Update

January 19, 2018



## Periphery Revival Spearheaded by Greece

A continued benign backdrop and looming credit rating upgrades has push eurozone spreads tighter with new issues meeting strong investor demand.

Global bond yields have continued to drift higher over the past week, as equity markets have continued to climb to new highs, buoyed by robust corporate earnings and ongoing flows into more risky assets. Arguably, the notion that North and South Korea are talking to each other and will be collaborating at the Winter Olympics, has served to continue to diminish geopolitical concerns in the short-term and without an obvious ‘risk-off’ catalyst on the immediate horizon, it appears markets have seen this as a green light to continue on their recent path. As we have written in recent months, the taming of the (equity) bears has seen greed become the dominant driving force behind asset prices and, although this week’s 25% daily fall in the value of Bitcoin serves as a reminder that greed will ultimately end in tears, we would observe that the ‘Fear Of Missing Out’ on the rally appears to remain the dominant sentiment for now, in our meetings and dealings with other professional investors.

Newsflow has been relatively light in the past week, with US markets out on Monday for Martin Luther King Day. In the eurozone, there is a growing sense that Mario Draghi may start hinting at the monetary policy exit at next week’s ECB meeting but with QE balance sheet expansion set to continue through to September and rates only likely to rise 12 months from now, the backdrop remains benign and has been helped by declining perceptions of political risk. Eurozone spreads have continued to move tighter with new issues meeting strong investor demand. Spreads in Spain, Portugal, and Greece among others are now at their narrowest levels since the onset of the Euro sovereign debt crisis, as strong cyclical growth and conservative fiscal policies see debt to GDP ratios turn lower, reinforcing improving credit metrics at a sovereign level. Further credit rating upgrades are likely in the months ahead, with Spain likely to regain ‘A’ rated status before long in our view.

With Greece set to pass its latest programme review with flying colours and with long dated Greek government bond (GGB) yields some 250bps lower than they were just three months ago, we think 'BB' status for Greece may also be achieved relatively soon, when we reflect on how spreads are the best forward looking indicator for what rating agencies are likely to do in the future. Indeed – having witnessed how rating agency DBRS made a name for itself, keeping Portugal at BBB- throughout the crisis, when Portuguese government bonds spreads traded wide of where Greece currently sits today, we even wonder if a 'cheeky' BBB- outcome for Greece from one rating agency wanting to make a name for itself, could be a possibility in 2018; particularly if progress on debt sustainability measures are made during the course of this summer. We would also note, based on ECB interactions, that even if balance sheet expansion ceases in September 2018, QE purchases as a result of reinvestment is likely for several years to come. In this context, GGBs may well be eligible for ECB purchases later this year in our view – even if the country is no longer under a European Stability Mechanism (ESM) programme. Given these views, it is not surprising that Greece remains favoured in our eyes, with 5-year bonds looking attractive at a spread of 300bp over Bunds when similar dated Portuguese spreads have now shrunk to just 55bps.

We continue to reassess where an interruption in the risk rally is likely to come from and absent any substantial geopolitical risk, we continue to assess the scope for disruption as a result of shocks coming from either economic data or central bank policy. In this regard, data trends seem to exhibit low volatility for now and we can't see much change in the immediate future. Inflation may trend higher in Q2 but seasonal base effects are likely to contain this in the next month or two. Elsewhere, we sense that central banks remain relatively happy and relaxed with the global economy doing

well and price pressures relatively subdued. We are aware that there is some anxiety at the Federal Reserve (Fed) that monetary policy tightening to date has served to ease, not tighten, financial conditions. For now, we sense policy is pushing on a string in the same way it was when rates were cut below 2% in the first place, yet for now this serves as an endorsement for the Fed to continue on its gradual path of 25bp per quarter for the foreseeable future, rather than anything more dramatic.

One topic we are researching more intensively is trade policy, given its likely focus in Q1. We have thought Trump serving six months' notice on NAFTA was relatively likely in Q1 and that this could see Mexico and Canada underperform. However, we have been interested by worries that doing this could push Mexico towards a more populist AMLO administration in the upcoming elections and it is hard to see how this would be in the US interest. Nevertheless, trade is an emotive issue and our sense from Ottawa is that Canada is disinclined to give the US what it wants. Trade policy is a potential source of volatility – yet when it comes to China, we are also struck by the idea that Trump is enjoying his status as the father of the 'Greatest Stock Market Rally... EVER' and won't want to disrupt this status as we head towards the midterms in the months ahead. This leaves much to think about in the weeks to come and we are sure that much of the coming year will be more challenging than its start.

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