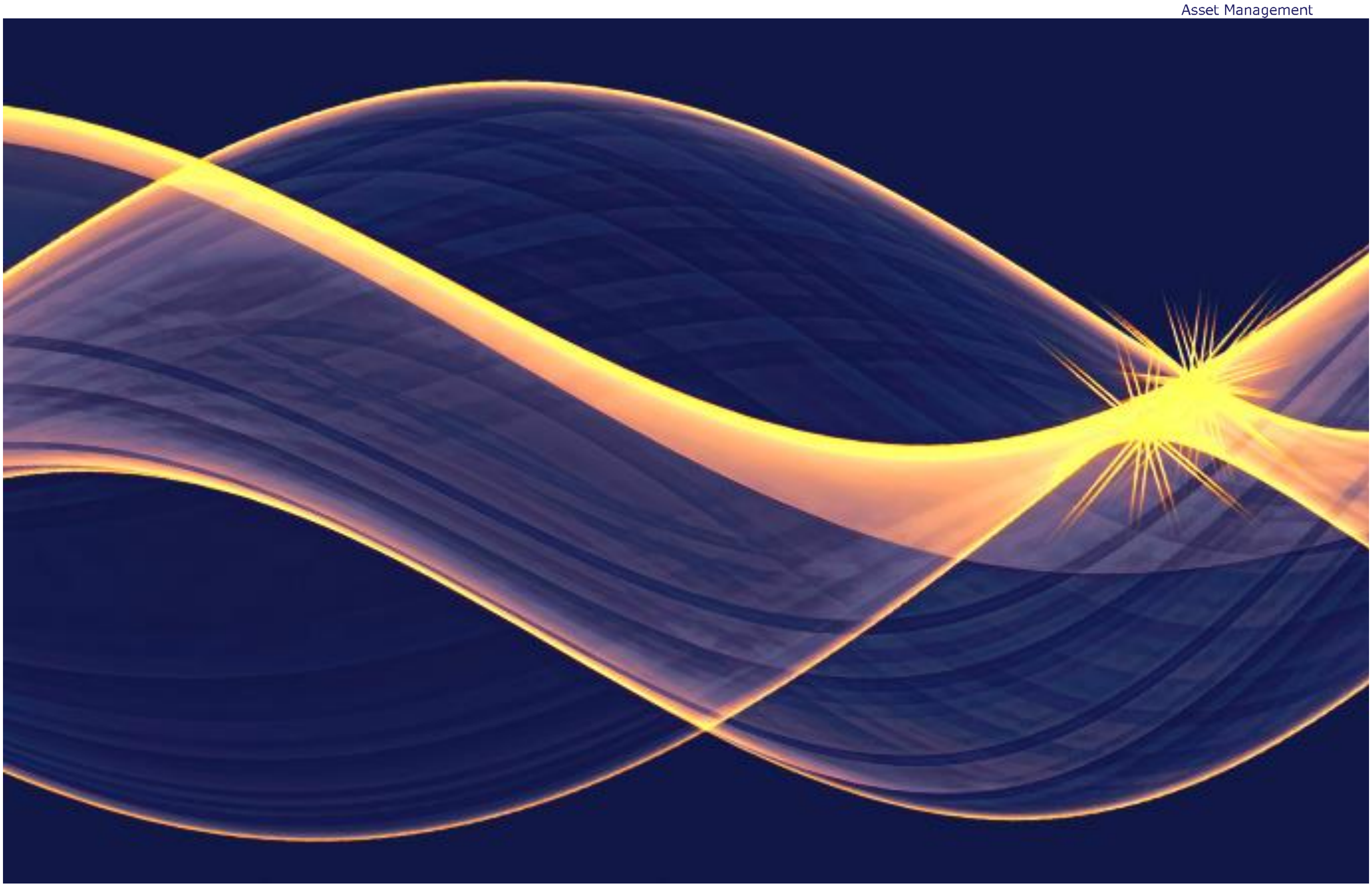

Reflation redux

Head of Credit Strategy, David Riley, discusses the key themes in fixed income markets, where investors can find pockets of value and the potential surprises that lie ahead.

Market Insight

by
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Global stock markets are rising and market volatility is at all-time lows. Are investors complacent?

Recent economic data confirms the synchronised global economic upturn. This even extends to emerging markets (EM) that are growing at the fastest rate since 2012. The fear of global deflation that has haunted markets in recent years has been banished and warrants a rise in growth-sensitive risk assets. Global reflation also goes hand-in-hand with peak quantitative easing (QE) and we believe we are now past the point of maximum central bank asset purchases and the era of lower-for-longer interest rates.

In that respect, we do think that markets are complacent about the outlook for interest rates and duration is the biggest single risk facing fixed income investors' portfolios. In our opinion, the Federal Reserve will hike rates in June and a further six times by the end of next year.

You are right that market volatility is low, but there is more going on under the surface with greater dispersion and less correlation in asset performance. The experience of the last episode of prolonged low volatility in 2014 is that 'idiosyncratic' risks can bring it to an end, but that more fundamental fears are required to lead to a more meaningful drawdown in risk assets. Volatility may be low but markets are not euphoric.

What are the key issues that investors should watch over next few months?

Fears around political risk are currently dominated by the French presidential elections in April/May**.** The market is pricing in around a 30% chance of a victory for the anti-establishment candidate Marine Le Pen that we believe more than fully prices the risk**.** Non-European investors in particular are too focused on political risk and are failing to recognise Europe's improving economic fundamentals.

Investors should also keep a close eye on the Organisation of the Petroleum Exporting Countries (OPEC) as we think they will extend production cuts into the second half of 2017 at their meeting at the end of May - that will provide a floor on oil prices at around US$50 per barrel.

We also expect much greater clarity on US tax cuts and infrastructure spending before Congress's summer recess in July. That said US assets, especially stocks, are potentially vulnerable to policy disappointment.

How are these themes and risks reflected in some of BlueBay's multi-asset credit and other strategies?

In our multi-asset strategies, we are fully invested and we have increased our exposure to banks (bank capital) and EM where we think there are pockets of value and good opportunities for generating additional returns through credit and country selection.

More generally, we are long credit risk and underweight interest rate risk. That means we favour higher–yielding, shorter-duration credit, including convertible bonds. We are also positioned in some strategies for compression in spread across the credit spectrum. In addition, we are using liquid hedges to tactically manage market risk

What are the potential surprises over the coming months?

Fears of populism in Europe prove over-done and we enter the second half with the prospect of greater integration rather than political and economic fragmentation.

The ECB reducing liquidity faster than markets anticipate could be a potential banana skin. However, we think this is more a second half rather than second quarter 2017 issue, but the ECB is on an exit path from negative rates and QE and this should offer good investment opportunity potential for nimble investors.

On the downside, if the Trump administration chooses to prioritise trade protectionism over tax cuts, expectations of faster US growth and earnings that underpin US stocks, and to some extent credit, would be disappointed and markets would have to re-price the winners and losers from the new regime.

Overall, we are not complacent about the risks – political, protectionism as well as the structural challenges facing China that have not gone away, even though growth has stabilised. We believe that, for the next few months at least, credit and carry type assets offer relatively attractive risk-adjusted returns.