BlueBay
Asset Management

2020 Global Investment Outlook

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Executive summary

Global growth is near a point of positive inflection and recession fears should ease. The easing in financial conditions, moderation in the drag on growth from the US-China 'trade war' and credit and policy-supported stabilisation of the Chinese economy should support a pick-up in global growth in 2020. Several major emerging market economies are recovering from recession. The industrial and auto led-slowdown in Europe has troughed and rising employment and household income underpins continued trend growth in the US.

The forecast recovery is subdued compared to the rebound from the 2015-16 economic downturn and downside risks predominate. The 'phase one' trade deal between the US-China is not yet agreed; an escalation in trade tensions between the US and EU still cannot be discounted; and political uncertainty remains elevated. The global economy is characterised by low growth and high debt, rendering it vulnerable to adverse shocks.

Political uncertainty, social unrest and environmental risk will be reflected in greater dispersion and idiosyncratic risk, best captured, in our view, by bottom-up credit selection and from incorporating and monitoring ESG risks in investor portfolios. The rising incidence of civil unrest in developed as well as emerging economies; technological disruption; nationalism over globalisation; and the demand from asset-owners for their investments to positively contribute to tackling climate change will be important themes for 2020 and beyond.

Mediocre growth and subdued inflation will keep central banks on hold but should be sufficiently positive to keep default rates low, creating an environment in which credit typically delivers relatively attractive risk-adjusted returns. Ultra-low yields on core government debt, especially in Europe, renders investment-grade corporate credit the new 'quasi-safe' asset. But with dispersion and idiosyncratic risk on the rise, bottom-up security selection in leveraged credit is even more important.

In the absence of bold political action, investors are trapped in an environment of 'QE-infinity' and persistently low to mediocre growth. Yet the distortions from never-ending central bank liquidity and ultra-low interest rates are becoming systemic. Resources are captured by rising numbers of zombie companies surviving on easy financing, reinforcing the underlying problem of low growth.

A positive inflection in growth will support spread compression and a partial catch-up for assets and sectors that have underperformed over the last year. Yield curves will bear steepen with central banks on hold; growth-sensitive cyclical assets should outperform, as will lower-quality credit. The improvement in growth prospects beyond the US will support emerging market assets, notably local currencies and debt.

With dispersion and idiosyncratic risk on the rise, bottom-up security selection in leveraged credit is even more important

Positive inflection

In our view, investors remain too fearful of a global recession and we expect a modest pick-up in growth in 2020. The easing in monetary and financial conditions and a moderation in the drag from the US-China trade war should support growth in 2020.

The credit impulse in China is now positive and is likely to be backed by further fiscal and monetary support with the inventory cycle in manufacturing turning from a headwind to a tailwind for global trade and growth. Although we expect a more subdued bounce-back than from the 2015-16 slowdown, a positive inflection in global growth should dispel recession fears with meaningful implications for markets.

Much depends on a US-China trade deal for business sentiment and investment to improve and for the Trump administration to refrain from ratchetting-up trade tensions with the EU, as it has threatened to do.

The escalation in the US-China tariff war and trade policy uncertainty has had a meaningful downward effect on global trade and investment, although the coincidental cyclical slowdowns in autos and semi-conductors, and tightening in global monetary conditions in 2018, also played a big role.

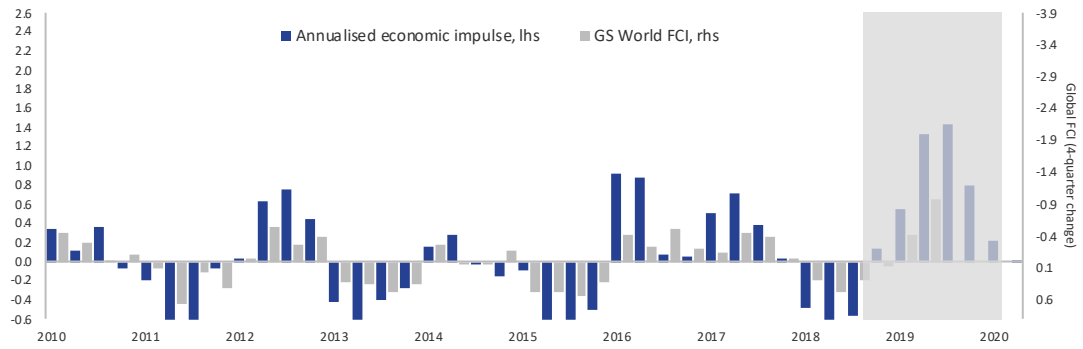
If the anticipated US-China 'phase one' trade deal does not materialise, further tariffs and the adverse impact on financial conditions and business investment could de-rail the recovery.

And trade is not the only source of uncertainty as the race for the US presidency heats up. Signs of growth stabilisation in China are tentative at best and the risk of policy error by Beijing in providing insufficient stimulus cannot be wholly discounted.

We do not expect a repeat of the notable rebound in growth as occurred after the last global recession scare in 2015-16. Investors are likely to remain cautious until economic data provides greater evidence that the 'green shoots' of recovery are firmly established.

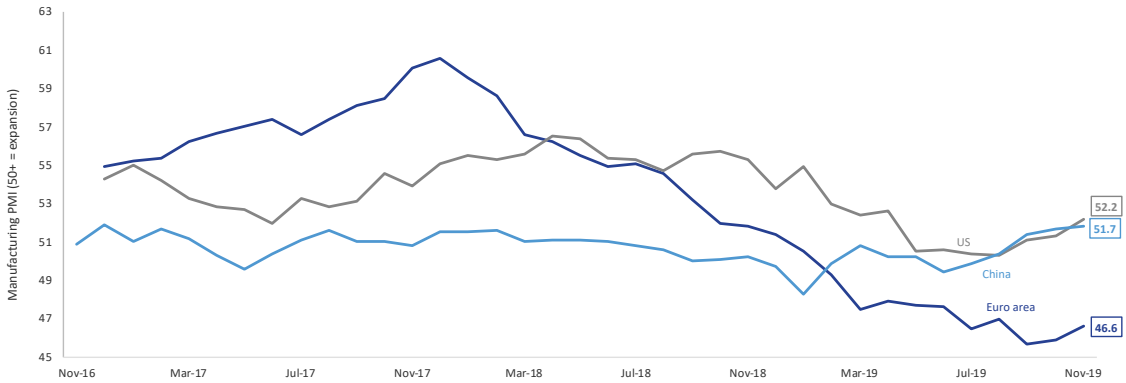
If the anticipated US-China 'phase one' trade deal does not materialise, further tariffs and the adverse impact on financial conditions and business investment could de-rail the recovery

CHART 1: EASING IN GLOBAL FINANCIAL CONDITIONS SET TO BOOST GLOBAL GROWTH



Note: As of 10/30/2019. Real GDP growth impulse from Goldman Sachs (GS) World Financial Conditions Index based on GS estimates of impact of FCIs on GDP growth, with the assumption that financial conditions remain the same for the rest of the year and the following quarters. Source: Goldman Sachs, Bloomberg, RBC GAM

CHART 2: MANUFACTURING DOWNTURN HAS TROUGHED



Source: IHS Markit, China Federation of Logistics & Purchasing 11/2019, 11/2019, 11/2019

The US Federal Reserve's (Fed) dovish pivot has effectively eased monetary conditions by an equivalent of 150 basis points (bps), with Treasury yields moving from reflecting an expected peak in policy rates of around 3% to current expectations of just 1.5%.

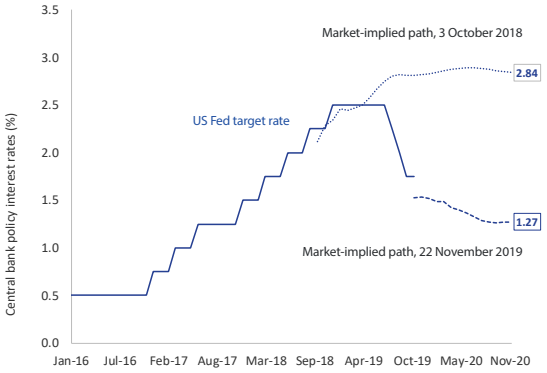
The travails of the shale oil sector have contributed to the decline in US business investment, but along with some easing in trade-related uncertainty, it should be less of a drag in 2020. Lower mortgage rates are boosting household incomes and driving a pick-up in housing starts. Real wages are rising and jobs growth remains at a pace that should continue to reduce unemployment. So long as the labour market remains strong, then we believe the US consumer will prevent the US economy from stagnating.

The latest eurozone economic data suggests that conditions in the industrial sector are improving. Fiscal policy is mildly expansionary in 2020, but the reluctance of German policymakers to use ample fiscal space to boost spending remains a source of downside risk, in our view, with monetary policy near the point of exhaustion.

The shadow of a 'no deal' Brexit has at last been dispelled, although uncertainty over the post-Brexit trading relationship with the EU persists. Irrespective of the outcome of the current UK general election, public spending and borrowing is set to rise. We predict growth in Japan will remain below 1%, as in Europe, monetary policy has largely exhausted its ability to further boost growth and inflation.

China growth is on a secular downtrend and greater import substitution means its contribution to global demand will likely diminish over the medium-term.

CHART 3: THE FED'S 'DOVISH PIVOT'



Note: US dollar OIS forward rates at 3 October 2018 and 22 November 2019. Source: Bloomberg, latest data at 22 November 2019

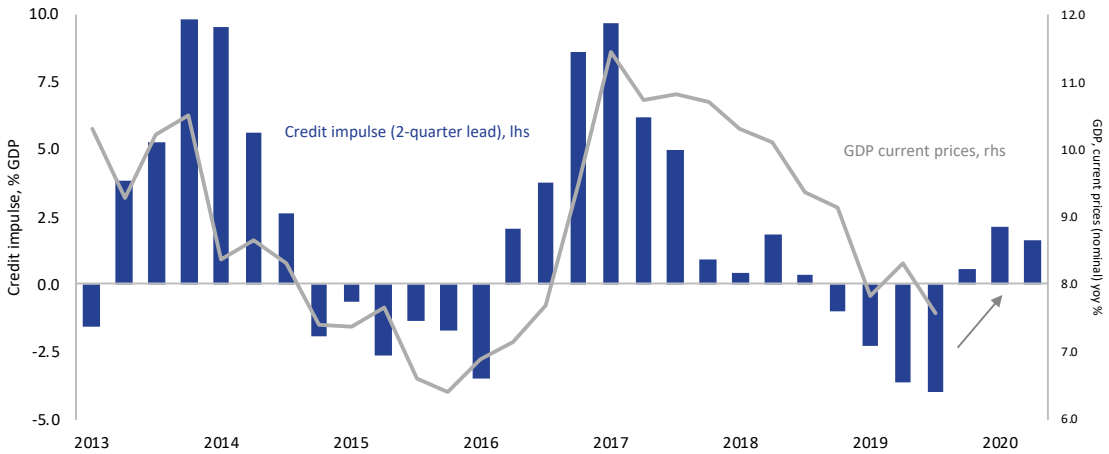
But in the near-term, a ceasefire in the tariff war with the US, easier credit and monetary conditions and a pick-up in infrastructure spending should drive a sequential pick-up in growth in the first half of 2020 that will also support activity across East Asia.

The latest IMF forecasts predict a recovery across the major emerging market economies, notably India, Russia, Mexico, Brazil, Russia and Turkey, helped by stable commodity prices and a pick-up in global manufacturing and trade[1].

The inventory drawdown is coming to an end and is likely to make a positive contribution to growth in 2020 as sales pick-up in key sectors. An increase in infrastructure spending at the turn of the year as well as a positive credit impulse, albeit modest by previous standards, will support a stabilisation of Chinese growth in the first part of 2020. The easing of monetary and financial conditions from the dovish pivot by global central banks, led by the Fed, is also supporting global activity.

The shadow of a 'no deal' Brexit has at last been dispelled, although uncertainty over the post-Brexit trading relationship with the EU persists

CHART 4: CHINA GROWTH WILL FOLLOW POSITIVE INFLECTION IN CREDIT IMPULSE



Source: People's Bank of China; BlueBayAsset Management calculations; latest quarterly data for Q3 2019

[1] IMF World Economic Outlook, October 2019

Quantitative tightening is dead, long live quantitative easing!

Despite several years of sustained economic expansion and rising employment, the attempted unwinding of the extraordinary monetary policies of the post financial crisis era – quantitative tightening – proved short-lived.

Led by the Fed in early 2019, global central banks pivoted from tightening to easing in response to weakening global growth, persistently low inflation and trade policy uncertainty. The Fed brought an early end to the shrinking of its balance sheet that is once again expanding as it injects liquidity into short-term funding markets, while the European Central Bank (ECB) resumed large-scale and open-ended purchases of euro sovereign and corporate bonds.

With most of the world's central banks cutting interest rates, the global economy is benefitting from the most extensive monetary easing programme since 2010.

The Fed has set a high bar to unwind the 2019 'mid-cycle' rate cuts and will only do so if inflation rises persistently above its 2% target. Conversely, further rate cuts would only be prompted by a meaningful slowdown in jobs growth and a pick-up in unemployment.

The ECB has embarked on a strategic review of its monetary policy and stated it will 'continuously monitor the side effects' of its policies – an acknowledgement by new ECB President Christine Lagarde of the deteriorating cost-benefit calculus of negative policy rates and QE[2] . Like the Fed, the bar for a shift in policy from the ECB is high.

With major central banks set to keep policy rates unchanged through 2020, a pick-up in growth should lead to some modest bear steepening of yield curves. But were growth to accelerate by more than forecast, a more meaningful re-pricing of inflation risk would follow.

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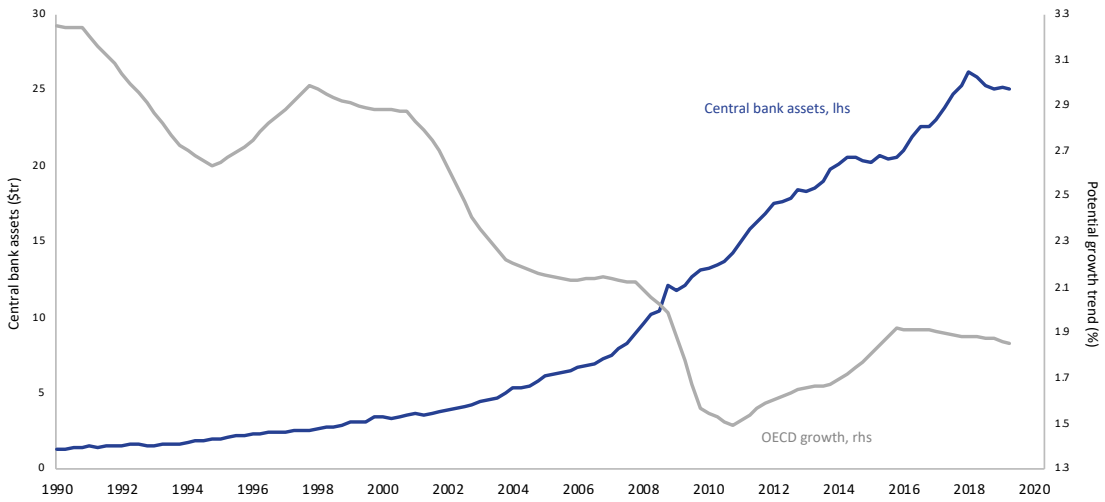
CHART 5: QE ANAESTHETIC FOR DECLINING GROWTH



Source: OECD; Macrobond; latest quarterly data for Q2 2019

[2] The future of the euro area economy, speech by ECB President Lagarde, 22 November 2019

The positive impact on economic growth and inflation of quantitative easing (QE) is diminishing – we are approaching the point of monetary exhaustion. QE and ultra-low interest rates have become an anaesthetic for declining global growth and excessive debt. But extraordinary monetary policies largely reflect the trend decline in productivity growth and real (inflation-adjusted) interest rates that pre-dates the global financial crisis, as well as the failure of governments to implement reforms that boost productivity and aggregate demand.

Even modestly positive real interest rates prove unsustainable in a world of persistently low nominal, as well as real, growth and high debt. Yet the distortions from never-ending central bank liquidity and ultra-low interest rates are becoming systemic. Resources are captured by rising numbers of 'zombie' companies surviving on easy financing, reinforcing the underlying problem of low growth.

Negative policy rates and quantitative easing have become persistent and pervasive features of the landscape facing investors across much of the world.

Traditional financial institutions – banks, insurance companies and pension funds – struggle to effectively allocate investment capital against the backdrop of negative yielding debt and nominal policy rates.

With lower-for-longer rates and bond yields firmly entrenched, investors are forced to take more risk to meet their return targets. Investors have moved further out on the yield curve and take ever more duration in their portfolios, rendering their bond holdings more vulnerable to even small increases in interest rates.

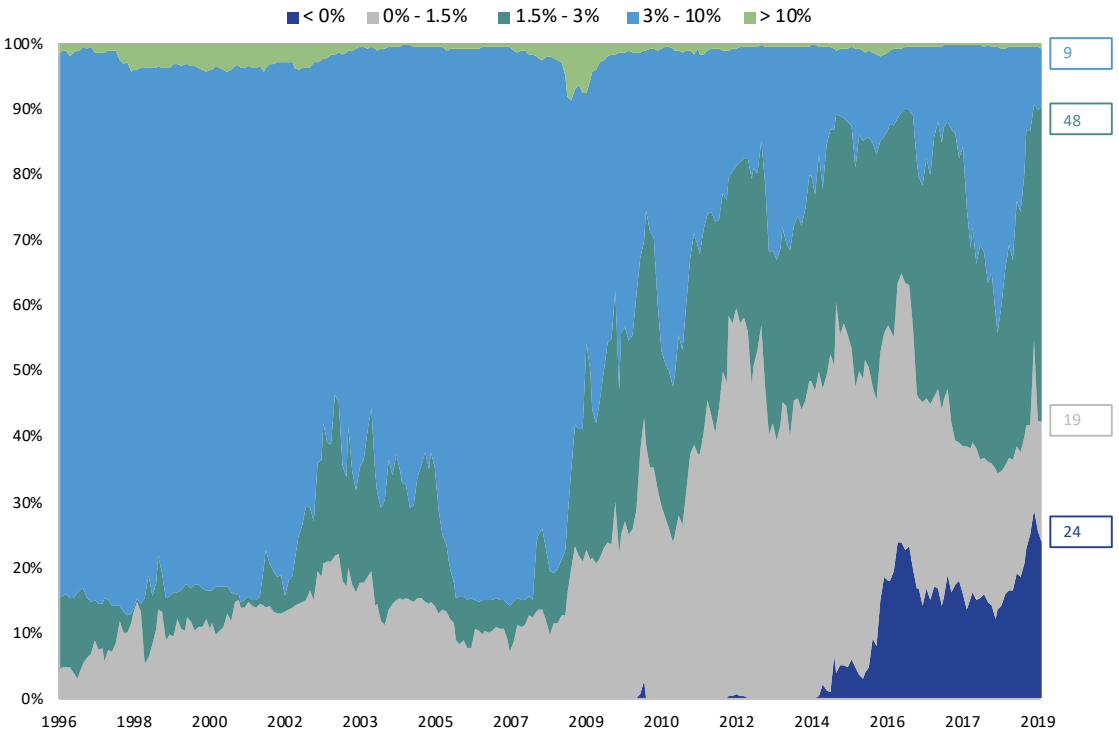
The search for yield is driving an increasing share of capital into alternative assets, such as private debt and infrastructure, as well as into credit and to a lesser extent emerging markets debt.

Investors are also adopting a 'barbell' between passive approaches to gain low-cost access to market 'beta' and total return strategies. The latter actively manage duration and credit risks unconstrained by benchmarks and thus have the potential to better exploit relative value and idiosyncratic opportunities to generate additional return and diversification.

Investors are being forced to take more risk in the search for yield. Interest rate, credit, liquidity and manager (or alpha) risk must all be understood and responsibly managed.

With lower-for-longer rates and bond yields firmly entrenched, investors are forced to take more risk to meet their return targets

CHART 6: GLOBAL FIXED INCOME MARKET BY YIELD BUCKET



Source: BofAML Global Fixed Income Index; October 2019

Mediocre is good

In a world of mediocre growth that is not strong enough to prompt central banks to hike rates but is consistent with a low incidence of defaults, credit typically outperforms in terms of risk and volatility-adjusted returns.

Over the last twelve months, the shadow of rising recession risk has prompted investors to favour higher-quality over low-rated and cyclically sensitive credit. But even with the mediocre recovery in the global economy that we anticipate, there is room for catch-up in performance from lower-rated and cyclical credit.

Credit potentially offers low volatility and positive returns in a world of mediocre growth not too hot to prompt central bank rate cuts and not too cold to raise default rates.

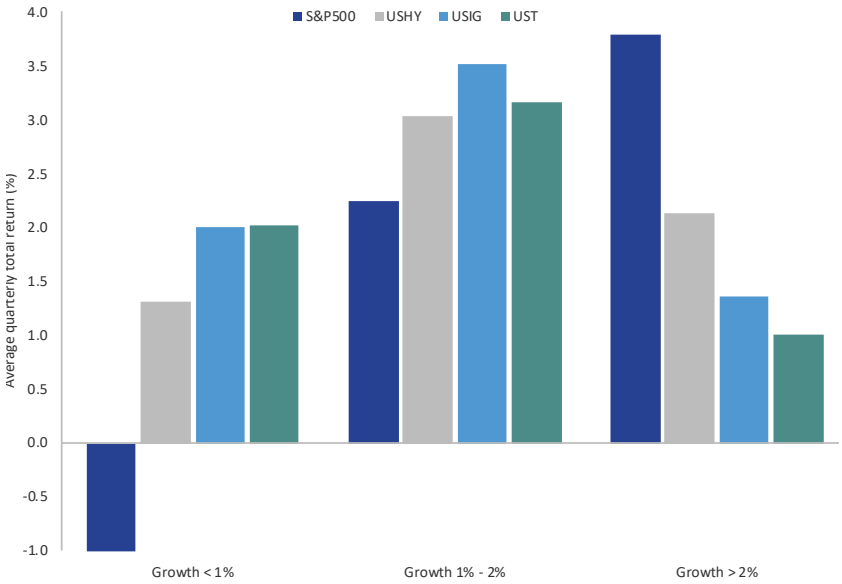
In Europe, investment-grade corporate credit has become a quasi-safe asset for many investors unwilling to hold negative-yielding, high-rated European sovereign bonds. The ECB is committed to buying EUR20 billion of bonds every month until inflation sustainably converges to its near 2% target, of which EUR4-6 billion is purchases of investment-grade corporate bonds.

In our opinion, investor, as well as ECB, demand for investment grade credit could see a further grind tighter and compression in spreads between higher and lower-rated debt, even if eurozone economic data remains tepid.

There is approximately USD12 trillion of negative yielding debt (mostly European and Japanese government bonds), accounting for almost one-quarter of global fixed income assets. Only some 10% of debt issued in the major domestic and Eurobond markets yields 3% or more – mostly sub-investment grade-rated developed market credit and emerging market debt[3].

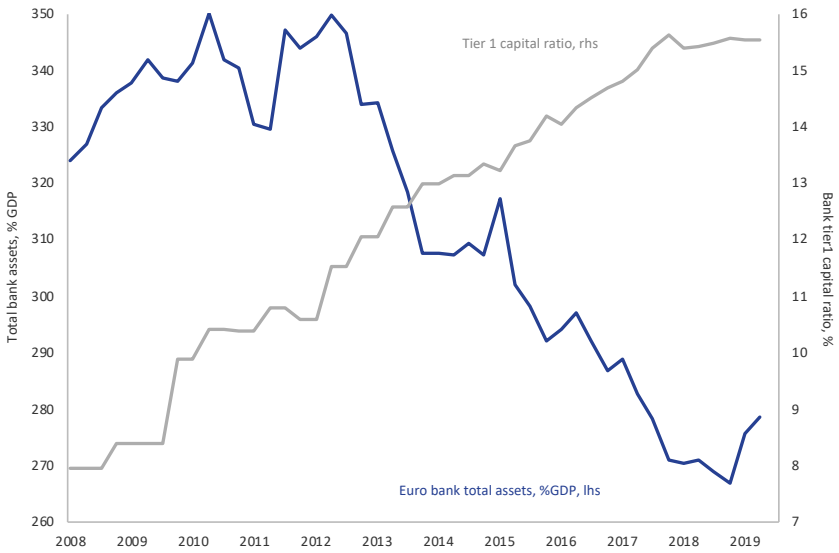
Against this backdrop, the subordinated debt of investment grade-rated companies and banks offers attractive risk-adjusted yields. European bank debt, especially contingent convertible bonds (cocos), offers mid-single-digit yields and a meaningful spread pick-up over similarly rated non-financial corporate debt.

CHART 7: MEDIOCRE GROWTH IS GOOD FOR CREDIT



Note: average quarterly total returns; USHY (BAML US High Yield Master 11, HOAO); US IG (BAML US Corporate Index, COAD); UST (BAML US Treasury & Agency Index); and S&PS00 total return index in the quarter with US GDP growth below 1% (SAAR); 1%- 2%; and above 2%. Latest data for Q3 2019

CHART 8: EUROPEAN BANKS IMPROVING CREDIT FUNDAMENTALS



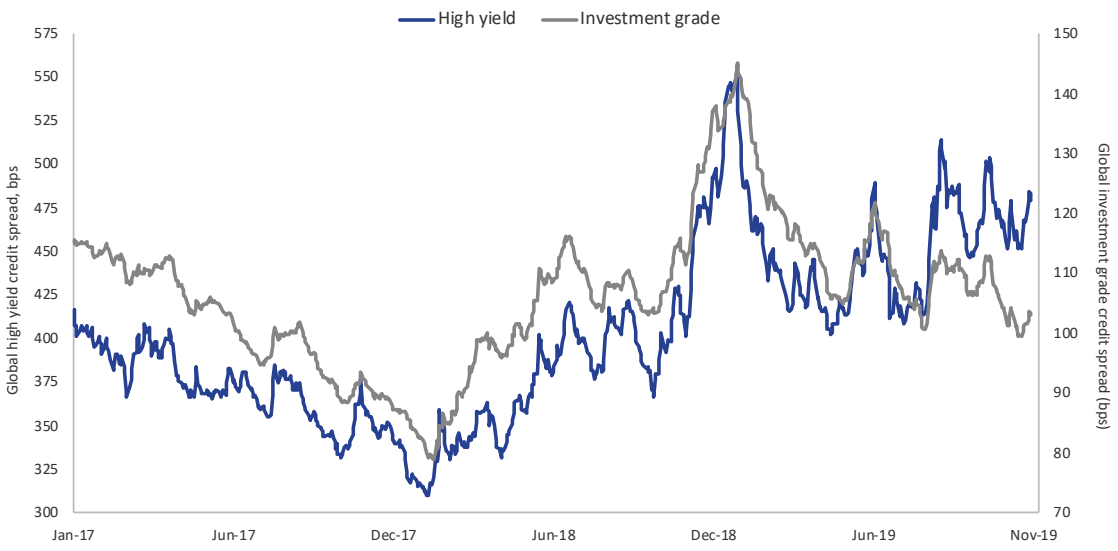
Source: ECB (European Central Bank), Eurostat 2019 Q2, 2019 Q2

Rating agency and regulatory changes could also be supportive of the asset class in 2020 and it remains a core holding across BlueBay multi-asset and credit strategies.

Bank credit fundamentals have improved dramatically since the global financial crisis and bank debt capital offers among the most attractive risk-adjusted returns in a low-yield environment.

[3] ICE BofAML Global Fixed Income Markets Index (cUSD55 trillion market value), October 2019

CHART 9: GLOBAL INVESTMENT GRADE & HIGH YIELD CREDIT SPREADS



Source: Bloomberg; latest data at 22 November 2019

Credit potentially offers low volatility and positive returns in a world of mediocre growth not too hot to prompt central bank rate cuts and not too cold to raise default rates.

In a low yield world, US and emerging market (EM) 'hard currency' credit continues to attract inflows from global investors seeking yield. Currency hedging improves the yield opportunity set for North American investors with returns on euro-denominated debt boosted by more than 2% by hedging back into US dollars (and why 'reverse Yankee' issuance by US companies of euro-denominated debt will continue to be an important source of supply). For Asian and European investors, the funding cost of US dollar assets and flat Treasury yield curves erodes much of the additional yield on offer from US fixed-income and credit, although investors are increasingly taking currency unhedged exposure.

The heavy supply of bonds has been a persistent performance headwind for US investment-grade debt, but in 2020 is expected to be around USD400 billion – down by more than 20% from 2019 and approximately half the record highs of 2017[4]. Moreover, low rates, a bounce-back in corporate earnings and investor (and rating agency) pressure on BBB-rated companies to reduce leverage should be supportive of credit fundamentals after several years of gradual deterioration. The combination of stable credit fundamentals and improving supply-demand technicals should keep credit spreads well-behaved and allow coupon plus returns (some 3%-4%) in 2020, in our view.

In leveraged finance markets, 2019 was characterised by a rise in dispersion and rising idiosyncratic credit risk, as well as stress in the US high yield energy sector. We believe the rewards from bottom-up fundamentally driven credit selection is greater than ever.

The lowest-rated segments of the global high yield market have underperformed higher-quality BB-rated and less-cyclical credit. Yet non-energy default rates are expected to remain low and, despite the spread tightening this year, investors are fully compensated for actual and expected default risk in a mediocre but positive growth environment. Convertible bonds can potentially capture a share of the equity market upside while preparing portfolios to weather episodes of volatility.

There is room for lower-rated credit, especially in leveraged finance, to catch-up after lagging higher-quality debt in 2019. But greater dispersion and idiosyncratic risk underscores the importance of bottom-up credit selection.

[4] BofAML, 2020 US IG Outlook, 19 November 2019

Leveraged loan performance has notably lagged high yield bonds in 2019. The switch from rising to falling interest rates rendered the floating-rate feature of loans less attractive to investors with persistent outflows from US retail investors. In addition, erosion of covenant protections for creditors and rising leverage of new loan issuance to fund leveraged buy-outs and dividends against the backdrop of weakening growth has resulted in a rise in loans trading at distressed prices (80 cents or below).

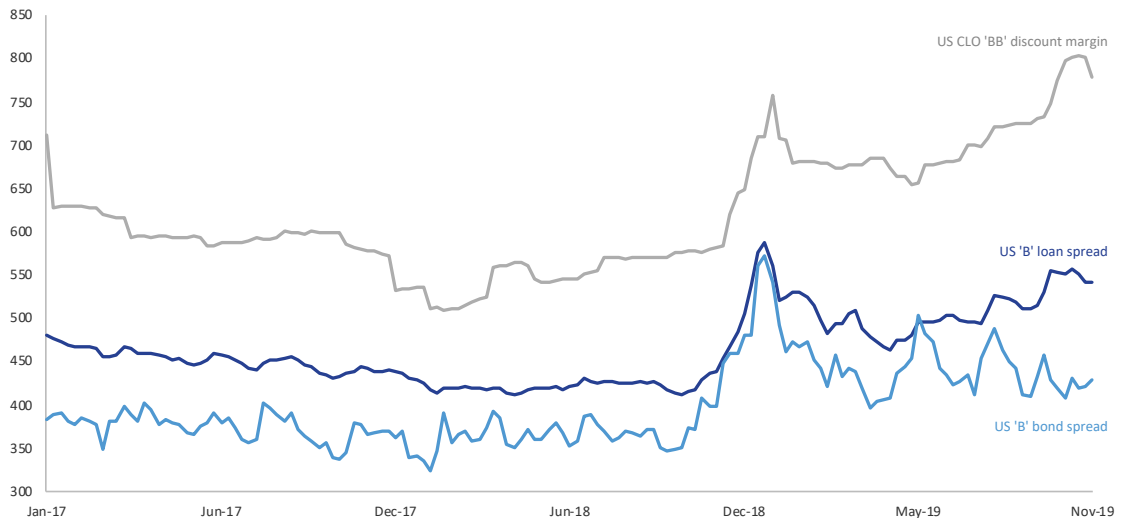
If our forecast for a pick-up in the global economy is realised and rates remain on hold, the demand for low-duration credit products will likely increase.

Credit spreads on collateralised loan obligations (CLOs) have widened, even relative to similarly rated loans. In part, the underperformance of CLOs is due to adverse supply-demand dynamics that is likely to correct in 2020 with reduced issuance, as well as fears of a wave of rating downgrades on loan collateral. The spread pick-up on BB and low investment grade-rated ('mezzanine') CLO tranches is the greatest since mid-2016. For investors able to take advantage of dispersion in credit markets, we believe CLOs are an attractive option, subject to careful analysis of CLO managers, the underlying collateral and the documentation.

The rise of total return credit strategies that can invest across geographic markets and various credit sub-classes provides investor acknowledgement of the benefits of a strategic allocation to credit unconstrained by a single market, credit asset and benchmark.

If our forecast for a pick-up in the global economy is realised and rates remain on hold, the demand for low-duration credit products will likely increase

CHART 10: WIDENING US LOAN & CLO SPREADS



Source:BofAML US High Yield 'B'; JPMorgan US 'B' loan & CLO 'BB' discount margin; latest data at 22 November 2019

Seeking value in emerging markets

Emerging market 'hard currency' corporate and sovereign debt posted robust returns in 2019, despite poor global growth and a firm US dollar. Valuations at the start of the year were attractive and Fed rate cuts and falling Treasury yields provided a powerful tailwind for USD-denominate emerging market debt. Credit spreads have tightened this year but remain elevated compared to similarly rated debt in developed markets. But the boost from lower US rates and Treasury yields is unlikely to be repeated.

A US-China trade deal and inventory-led modest global recovery would be unequivocally positive for emerging market economies and assets, especially equity and currencies that global investors are currently underweight.

An acceleration in growth in the rest of the world relative to the US is typically associated with a weaker US dollar, while emerging market currencies, in aggregate, are cheap to fairly valued by historic standards. With low inflation and relatively high real interest rates in several emerging markets, local currency debt offers attractive return opportunities, in our view.

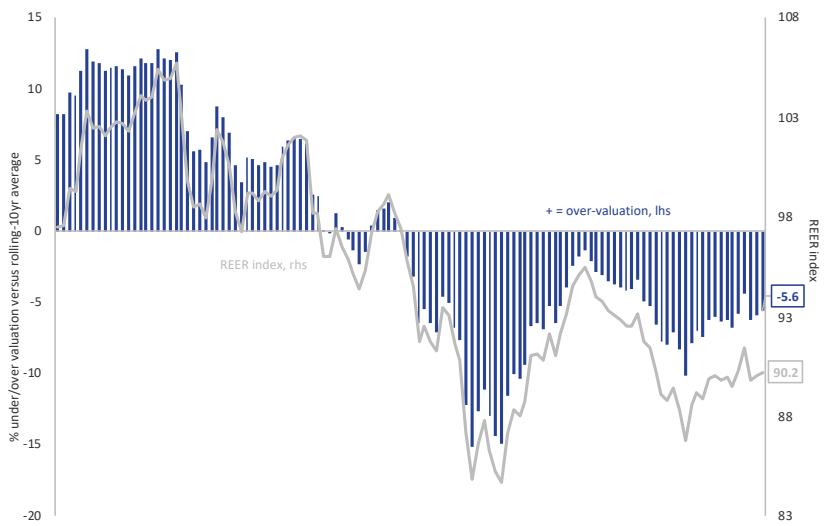
Idiosyncratic political and sovereign credit risk was the defining feature of emerging markets in 2019.

Populism and political risk were defining features of many emerging markets in 2019, especially in Latin America with protests in Chile and Ecuador, a political crisis in Bolivia and the return of the populist Peronist administration in Argentina. Ukraine and Turkey were also been buffeted by geo-political tensions. Venezuela remains in sovereign default and could be joined by Ecuador, Argentina and Lebanon.

The opportunity set for credit pickers seeking meaningful capital appreciation from distressed sovereign, as well as corporate, credit is wide and deep and is a potential source of return that is only weakly correlated to US rates and the dollar.

Volatility in sovereign risk has obscured the improved credit fundamentals of the corporate sector and contributed to the widening valuation gap between emerging and developed market corporate credit. Our bottom-up projections suggest only a small increase in the annual default rate to around 3%, compared to 2.5% in 2019.

CHART 11: EMERGING MARKET CURRENCIES UNDERVALUED BY HISTORICAL STANDARDS



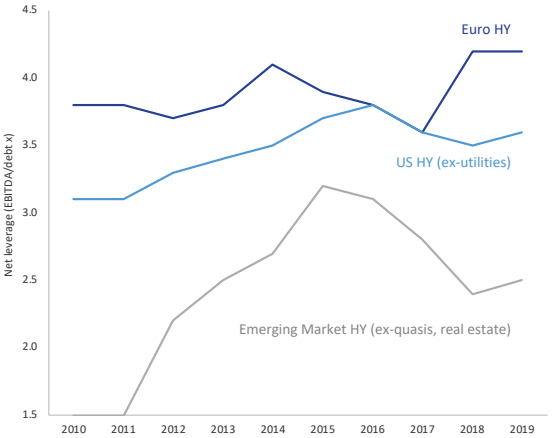
Source: BIS (The Bank for International Settlements), Intercontinental Exchange (ICE) 10/2019, 10/2019

The global macroeconomic backdrop is conducive to local currency emerging markets performing positively. We also see pockets of value in the EM high-yield corporate market and the opportunity set in distressed sovereign as well as corporate credit.

The challenge for investors is accessing the return and diversification benefits from EM assets in a manner that limits periodic drawdowns and volatility associated with the asset class. Investors are increasingly attracted to strategies that can exploit opportunities across sovereign and corporate credit, hard and local currency debt.

Volatility in sovereign risk has obscured the improved credit fundamentals of the corporate sector and contributed to the widening valuation gap between emerging and developed market corporate credit

CHART 12: LOWER CORPORATE LEVERAGE IN EMERING MARKETS



Source: JPMorgan; latest quarterly data for Q2 2019

A climate for change

Political tensions are heating up within and between countries as a decade of stagnation fuels dissatisfaction with the status quo.

'Make America Great Again' is a nationalist call to action that is being mimicked by other global leaders and challengers. Multilateralism is under strain, as is the 'liberal market' economy and governance from the left of the Democratic Party in the US and Labour Party in the UK, as well as from the right under presidents Trump and Bolsonaro. The populist march and 'de-globalisation' is not unchallenged nor irreversible, but more nationalist and interventionist governments are set to feature in the policy landscape facing investors for the foreseeable future.

Despite an easing in trade tensions between the US and China, if, as expected, a 'phase one' deal is struck between President Xi and President Trump, the strategic rivalry between the world's two most powerful nations will persist. We believe the polarisation of politics will continue to be a source of uncertainty and volatility.

Elizabeth Warren may emerge as a formidable Democratic nominee for the US Presidency, raising the prospect of a radical and potentially disruptive change in the US policy regime for business and markets. The unrest in Hong Kong could end with a further fracture in relations, not only between China and the US, but also with the 'West' more generally.

Since the global financial crisis, investors have been fearful of 'black swans' – unpredictable left-tail risks. But investors and policymakers are only now waking up to the 'grey rhino' risk of political volatility and climate change.

Environmental degradation and climate change are high-probability, high-impact yet neglected threats – a 'grey rhino' risk to social and economic stability[5]. Sustainable investing can include the portfolio exclusion of companies and industries that do not meet specified ESG criteria; the integration of ESG factors into portfolios to improve risk-adjusted returns; and investing with the goal of generating positive environmental and social impacts as well as returns (impact investing).

Asset owners and managers are beginning to face up to their responsibilities and the contribution that they can make to address these profound social and environmental challenges.

The incorporation of ESG – environmental, social and governance factors – explicitly into the investment process is a rational response to rising environmental and political risks.

Political tensions are heating up within and between countries as a decade of stagnation fuels dissatisfaction with the status quo.

[5] The Gray Rhino: How to Recognise and Act on the Obvious Dangers We Ignore, Michele Wucker 2016

David Riley, Chief Investment Strategist

David joined BlueBay in September 2013 and is Partner and Chief Investment Strategist within the Chief Investment Office. He is a member of BlueBay's Investment Committee and asset allocation team that manages some USD6 billion of multi-asset credit strategies. David chairs the weekly Investment Forum of BlueBay's portfolio managers, as well as the monthly Corporate Credit Group. Drawing on more than 20 years of applied macroeconomic, policy and sovereign credit experience, David advises and coordinates the Investment Committee as well as developing and articulating BlueBay's broad macro and corporate credit views. David was previously global head of Fitch's Sovereign and Supranational Group, responsible for more than 130 ratings of the world's largest fixed-income issuers. Prior to Fitch, David was a senior economist at UBS Investment Bank and at HM Treasury where he advised on international economic and debt issues, including representing the UK at international debt restructuring negotiations at the Paris Club of Official Creditors. David holds an MSc from Birkbeck College, University of London and a first-class degree in Economics.