Asset Allocation Navigator

Third quarter 2019

Synchronised central bank policy easing and the truce in the US-China trade war agreed at the G20 Summit is a positive macro backdrop for risk markets. Nonetheless, after a strong first half of the year we realised gains and reduced the 'equity' risk in our multi-asset credit strategies (MAC) - as we approach what could prove a disappointing corporate earnings season. But we maintain a pro-growth and carry bias across our MAC strategies, with our preference for European bank subordinated debt and emerging market (EM) local debt. Trade policy tensions and global growth fears have not gone away, but in a world characterised by mediocre growth and even lower for longer interest rates, credit, including EM debt, can continue to post solid returns.

MARKET INSIGHT

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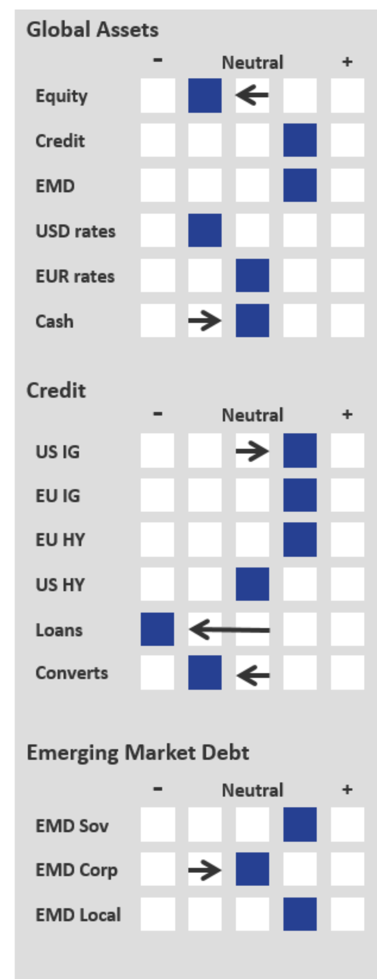
July 2019

TACTICAL ASSET CLASS PERSPECTIVE
(3–6 month outlook) [1]



Follow the flow

Financial markets in the first half of the year were dominated by the 'dovish pivot' by central banks, led by the US Federal Reserve (Fed), and trade policy uncertainty. Market expectations for at least three rate cuts by the Fed and policy easing from the European Central Bank (ECB) is fuelling a powerful rally in duration. Yet at the same time, growth-sensitive assets – small cap and EM equities along with low-rated credit – are under-performing even as risk markets have fully reversed the sell-off at the end of last year. Investors expect (and want) central bank liquidity, but are unconvinced it will be effective in raising growth and inflation. Apparent market scepticism that central bank liquidity will deliver a meaningful boost to growth in part is because a key driver of growth worries is trade uncertainty. Presidents Trump and Xi agreed at the G20 Summit a truce in the US-Sino trade war, not peace. The threat of additional US tariffs on Chinese goods remains in place, as does global auto tariffs. Corporate investment intentions and spending has weakened in the face of the uncertainty regarding trade policies. Semi-conductors and autos – two key global industrial sectors – are also facing structural as well as cyclical headwinds.

Sooner or (probably) later, Europe must complement monetary policy with fiscal stimulus. But for now the ECB is the only game in town and will deliver further monetary support in the hope that easier financial conditions will boost growth and inflation expectations. With more than half of Eurozone government bonds trading at negative yields, investors are moving into sovereign and corporate credit in the search for yield.

In a world of low default rates and central bank liquidity, credit is well-placed to generate positive returns and is less sensitive to corporate earnings disappointments. We think that solid consumer demand in Europe as well as the US and policy easing (from Beijing as well as Washington and Frankfurt) will be sufficient to at least stabilise global growth, so long as trade tensions do not intensify. This view is reflected in a modest pro-growth bias across many of our strategies. EM local debt offering high real interest rates can also perform against the backdrop of a range-bound US dollar and low volatility.

Credit

Credit has posted strong mid to high single digit total returns in the first half of the year, but this should be viewed in the context of a dismal performance through much of 2018. In our view, spreads have room to narrow further and compress, especially for low rated debt that has lagged the broader market rally. Although credit valuations are high by historical standards, valuations are less stretched in a world of structurally lower long-term interest rates.

In the event of the resumption of ECB bond buying – as we expect - sovereign as well as corporate credit is an unambiguous beneficiary. Despite the rally in sovereign peripheral and corporate credit spreads in June, in our view there is room for further spread compression if and when the ECB announces QE. Low rates and flat yield curve is not good for bank profitability and equity, but banks credit fundamentals remain strong. In our view, contingent capital (CoCo) bonds provide an attractive risk-reward profile with US dollar (USD) yields ranging from 5% to 7% and are a core 'over-weight' in our MAC strategies.

Emerging market debt

The tail risk of a near-term escalation in the US-China trade war is removed by the truce reached at the G20 Summit while global financial conditions are easing. We expect global growth and trade to stabilise and modestly pick-up in the latter half of the year. The global macro backdrop for EM economies is a positive one in our view.

In a low-yield world, the coupon income offered by EM 'hard currency' debt that is also less sensitive than EM equities to China and global growth concerns is attracting inflows from investors. Despite the rally in spreads so far this year, EM debt continues to offer around 100-150bps pick-up over similarly rated US credit.

Fed rate cuts and President Trump's warnings over 'currency manipulation' caps the upside for USD and low FX volatility is a favourable backdrop for EM local currency debt. Inflation in most EM's is moderate and real interest rates remain relatively high. In our view, selective EM local debt markets offer meaningful upside from a fall in rates and stronger currencies.

Rates

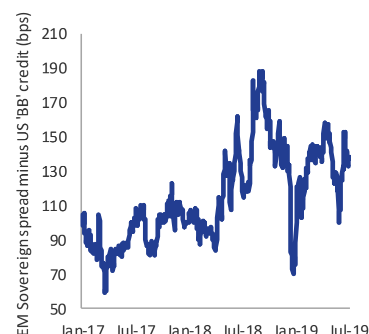
The latest leg of the global rally in duration followed ECB President Draghi Sintra speech with the credibility of the ECB's own 'dovish pivot', further enhanced by the nomination of Madame Lagarde as Draghi's successor. We expect a policy package of a cut in the deposit rate, probably accompanied by tiering of the deposit rate as a signal that the ECB can cut further into negative territory if it chooses to do so, as well as the resumption of asset purchases to be announced either at the July or September meetings of the ECB.

In the aftermath of the 'dovish' June Federal Open Market Committee (FOMC) meeting, US rates markets currently imply 100bps of cuts over the next twelve months. In our view, the Fed will cut rates by 25bps in July and possibly one more 25bps cut by the end of 2019. Our more bearish US rates view relative to current market pricing reflects our more bullish assessment of the state of the US economy, underlined by the continuing healthy pace of job growth.

FIG 1: EURO NONFINANCIAL CREDIT SPREADS

Source: BoAML Euro nonfinancial corporate credit (EN00); latest data at 5 July 2019

FIG 2: EM SOVEREIGN – US 'BB' RATED CREDIT SPREAD (BPS)



Source: JP Morgan EMBI Global Diversified spread index minus Barclays Bloomberg US 'BB' rated spread; latest data at 9 July 2019

FIG 3: NEGATIVE YIELDING DEBT

Source: Bloomberg; 5 July 2019

Note: 1 'Tactical asset class perspective' summarises the broad short-term tactical asset allocation views of BlueBay's Chief Investment Strategist and is consistent with positioning across BlueBay's flagship 'blended' and multi-asset credit strategies. The solid boxes reflect weights across asset and sub-asset classes (these 'weights' are indicative and do not relate to specific investment vehicles). The arrows indicate a shift in our tactical asset allocation since the previous Asset Allocation Navigator (2nd Quarter 2019 published in April 2019).

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