BlueBay
Asset Management

2019 Global Investment Outlook

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Macro themes for 2019

1. From QE to QT

Investment implication: As we move from the quantitative easing (QE) to quantitative tightening (QT) regime, micro factors – country, sector and issuer-specific – become more important. In addition to a greater emphasis on 'bottom-up' security selection, greater volatility and tactical asset allocation can also be a source of alpha. The new environment is fertile for active strategies that focus on rigorous bottom-up security selection and globally diversified investment strategies.

2. The multi-decade trend of falling inflation and interest rates is over

Investment implication: Investors must look beyond QE-diminished beta for fresh sources of returns and diversification for their portfolios. Unsurprisingly, investors are shifting to alternative approaches to fixed income that are not solely reliant on interest rate duration to drive returns and diversify equity risk.

3. Another year of solid global growth; fears of 'late cycle' and recession risk are premature

Investment implication: Going into 2019, European credit offers an attractive risk/reward profile, but greater dispersion and merger and acquisition activity means US credit offers greater alpha generation opportunities. A structural investment opportunity that remains in place despite disappointing growth and Italian political risk is European bank healing and disintermediation, which can be accessed in several ways to best reflect investors' risk appetite and liquidity profile.

4. Political uncertainty will create opportunities for ESG-savvy investors

Investment implication: Responsible investors are responding to the challenges posed by greater political uncertainty and climate change by incorporating environmental, social and governance (ESG) factors into their investment process. Ignoring ESG not only places investors' capital at greater risk but also precludes return opportunities that arise from the mispricing of ESG-related factors.

5. Value in emerging markets

Investment implication: Strategies that are nimble and able to position on the short side as well as the long side and are less constrained by benchmarks in their investment process are best placed to exploit the opportunities offered by emerging markets. Bottom-up selection becomes more important, favouring active investment based on the fundamental analysis of idiosyncratic risks.

"As central banks take away the proverbial punchbowl of quantitative easing, markets will be more volatile and returns will be lower even as the global economy continues to post solid growth.

Investors will have to be more selective with a greater focus on capital preservation to ensure they are not left naked as the tide of central bank liquidity goes out. Simply 'buying the market' will no longer work."

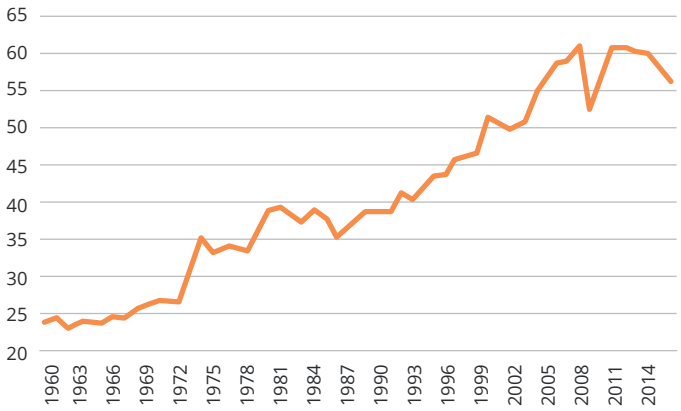
For the times they are a-changin'

In 1964, Bob Dylan expressed social unease and the hope for change during a period of political turmoil and economic transformation via his third album, *'The times they are a-changin'*. Over some fifty years following its release, globalisation, technology and the rise of financial capitalism and central banks as primary drivers of economic policy became the dominant features of the investment landscape.

Today, the world faces environmental, rather than nuclear, annihilation, a shift in global economic power from West to East, and the erosion of political and economic liberalism.

Globalisation is currently under profound challenge from the rise of populist politics and nationalism that exploits discontent with the status quo and the stagnation of real incomes in the aftermath of the global financial crisis.

GLOBALISATION, TRADE % OF GLOBAL GDP



Source: World Bank; latest annual data for 2016

The vehemence of political discourse disguises an emerging 'anti-globalisation' consensus of populism from the left and right, emphasising a nationalist economic policy agenda and rejecting multilateralism.

- President **Trump's** economic policy agenda is explicitly anti-globalisation
- **Brexit** is a rejection of European multilateralism
- The populist Five Star and League coalition governing **Italy** is railing against the eurozone's fiscal 'rules' and common immigration policies
- Nationalist populist leaders from left and right are gaining high office across **EM** economies
- Even **China,** a key beneficiary of globalisation, is becoming more assertively nationalist and is reducing its reliance on foreign investment and trade
- China, along with the rest of the world, must confront the profound challenges arising from **climate change** and environmental degradation that have economic as well as social consequences

Goldilocks and the three bears

A combination of volatility, political uncertainty and higher interest rates scared away the 'Goldilocks' environment (above-trend growth, below-trend inflation) of steadily rising investment returns.

In contrast to 2017's soporific (though rewarding) markets, 2018 has been characterised by several episodes of volatility including:

- the blow-up of 'short volatility' strategies at the start of the year
- the sell-off in EM assets and Italian government bonds
- multiple global equity market 'corrections' (falls of 10%+)

Very few asset 'betas' have generated positive total returns in 2018 and despite the episodes of volatility and equity drawdowns, core fixed income has offered little compensation, reflecting the regime shift from quantitative easing (QE) to quantitative tightening (QT).

QE

QE anchored 'very low for very long' policy interest rates and the commitment of central bankers to provide additional monetary easing in response to episodes of weaker growth and volatility.

More than USD9 trillion of central bank asset purchases created a tide of liquidity that lifted all asset prices, suppressed dispersion and volatility and elevated cross-asset correlations. Rewards from asset and security selections were eroded with returns dominated by the QE-induced 'beta' rally that favoured passive investment strategies.

QT

In the era of QT, central banks are no longer net buyers of financial assets and the most important of them, the US Federal Reserve (Fed), is shrinking its balance sheet and steadily raising interest rates. The European Central Bank (ECB) will stop buying bonds at the end of 2018 and the Bank of Japan (BoJ) is scaling down its asset purchases and allowing bond yields to rise, albeit very modestly.

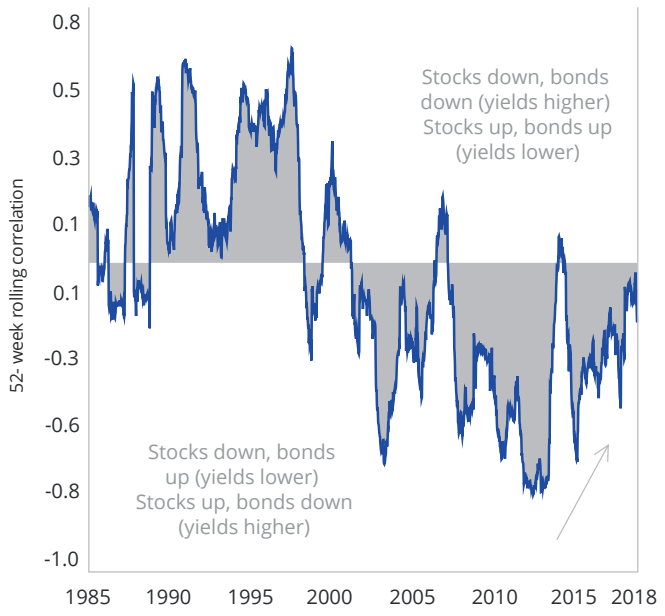
Global monetary policy has a tightening bias and in the language of options, the 'central bank put' (the commitment of central banks to put a floor on asset prices) is much more deeply 'out of the money'.

During the QE-era, the correlation between core fixed income (high-grade government bonds and short-term interest rates) and equity (or growth) risk was strongly negative and relatively stable. Central banks were more worried about deflation than inflation and soothed jittery markets with a monetary sedative. But with growth above potential and little in the way of economic 'slack', inflation is a greater risk than deflation and central banks are reversing the extraordinary monetary policies of the QE-era.

QE to QT: 10-second summary

- For the first time, the aggregate balance sheet of the world's major central banks will shrink in 2019, marking a decisive shift from the quantitative easing (QE) to quantitative tightening (QT) era.
- The reversal of QE – quantitative tightening – implies more frequent volatility episodes and greater reward from security selection and less stable correlation between equity and traditional fixed income.
- QT is unchartered territory for investors; favour alternative approaches to fixed income that are not solely reliant on interest rate duration to drive returns and diversify equity risk.

EQUITY & BOND CORRELATION LESS NEGATIVE & LESS STABLE



Source: Macrobond; BlueBay calculations; latest data 19 November 2018

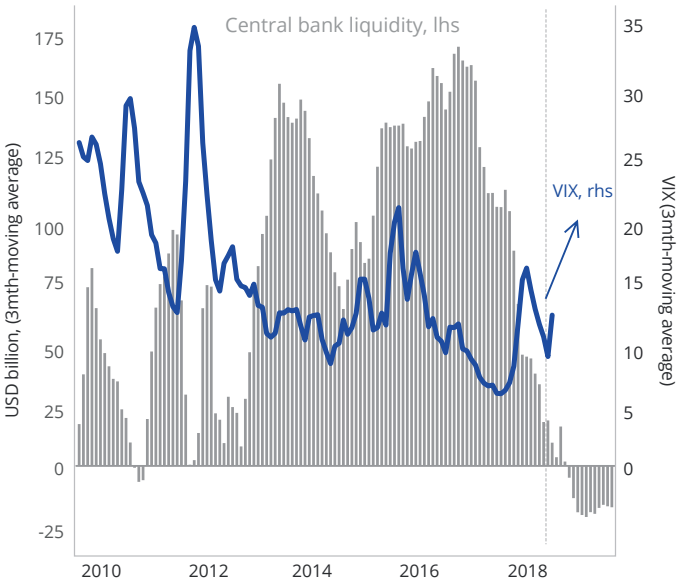
Regime change – the investment implications

The key investment themes that arise from the end of the QE-era, and at least partial reversal of globalisation, are complex.

In the words of Fed Chair Jerome Powell, central banks are effectively unwinding their 'short volatility position'. A higher-volatility market regime creates opportunities as well as risks for investors. Somewhat paradoxically, the diminished influence of common global macro drivers – QE and globalisation – increase the value of globally diversified investment strategies.

"In our view, the multi-decade trend of falling inflation and interest rates is over. Political as well as financial catalysts for market volatility abound."

QE SUPPRESSED VOLATILITY (VIX INDEX)



Source: ECB; Federal Reserve; European Central Bank; Bank of Japan; and BlueBay estimates and projections; latest actual monthly data for September 2018

Investors must look beyond QE-diminished beta for alternative sources of return and diversification for their portfolios.

Macro drivers dominated asset returns in the QE-era investment regime, characterised by high asset correlations and low volatility that favoured benchmark-tracking approaches solely targeting beta returns.

In the QT regime, micro factors – country, sector and issuer-specific issues – become more important, favouring active investments based on fundamental analysis of idiosyncratic risks. In addition to a greater emphasis on 'bottom-up' security selection, greater volatility and tactical asset allocation can also be a source of additional returns.

Uncertainty = ESG response

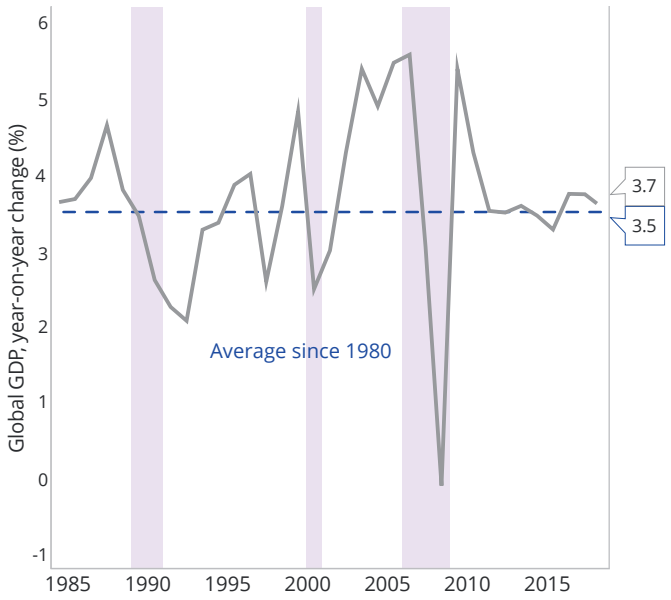
Responsible investors are adapting to the challenges posed by greater political uncertainty and climate change by incorporating environmental, social and governance (ESG) factors into their investment process. Investments that ignore environmental and social 'externalities' with a sole focus on financial profit and loss are unlikely to be sustainable and face much greater political risk and government intervention. Ignoring ESG not only places investors' capital at greater risk but also precludes return opportunities that arise from the mispricing of ESG-related factors.

Global economic outlook – recency bias

Investors are fearful of a marked slowdown in 2019 global growth, or even the possibility of recession, with growth-sensitive risk assets below their peaks in the first half of 2018. In our view, markets are placing too much weight on recent transitory weakness in industrial output in their assessment of the growth outlook and recession risk.

"We expect a pick-up in activity into the start of 2019 and for the global economy to expand at a rate of around 3.5%, consistent with solid corporate earnings and low default rates."

GLOBAL GROWTH FORECAST TO BE ABOVE TREND



Source: International Monetary Fund (IMF); October 2018
Note: Shaded areas denote NBER-dated US recessions

The **US** economy will enter 2019 with impressive growth momentum and the positive stimulus of tax cuts and extra government spending should not wane until the latter half of next year.

Japanese growth in the third quarter of 2018 was hit by natural disasters, but household income is rising at a solid clip and investment is expected to pick-up – some of it induced by preparations for the 2020 Olympics.

Recent weakness in the **eurozone** reflects temporary factors – notably a sharp fall in German auto production due to new emissions tests – as well as the unwind of the strong boost to growth from net exports in the latter half of 2017. But with financial conditions accommodative and domestic demand growth underpinned by rising household incomes and investment, growth is expected to be around 1.6% in 2019.

China is the 'delta' for global growth, accounting for approximately 40% of (nominal) global growth since 2010. China's economy is now as large as the eurozone and is the world's second-largest exporter of goods and third-largest importer. It is the most important export market for Japan and Germany (beyond the rest of the eurozone), and the dominant consumer of commodities.

Beijing has recently placed 'deleveraging' on pause and policy is becoming growth-friendly in acknowledgement of the slowdown in economic activity and the risks from the 'trade war' with the US. Our current assessment is that policy easing will be sufficient to deliver 6%+ GDP growth in 2019 and avoid a 'hard landing'.

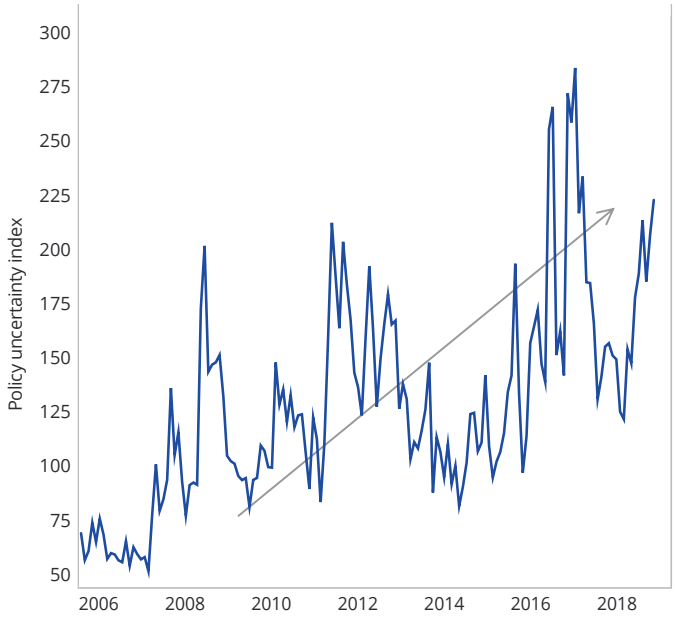
The downside risks to our base-case of above-average global growth and solid corporate earnings are meaningful and centre on China and trade. Beijing faces a difficult balancing act of supporting growth without abandoning the strategic goal of deleveraging and managing an orderly depreciation of the renminbi against the backdrop of the Fed steadily hiking rates. Additional tariffs on Chinese goods are more likely than not and the imposition of tariffs and quotas on global auto imports into the US cannot be wholly discounted.

China: 10-second summary

- The change (delta) in global growth ex-US is dominated by swings in the Chinese economy
- China growth peaked in mid-2017 as Beijing embarked on a deleveraging drive – but policies are now being eased, with a return to economic stimulus
- China growth stabilisation / upturn will boost global growth and the 're-coupling' with the US, but the trade war is a powerful headwind

Europe, as well as Asia, is vulnerable to intensification and broadening of trade tensions. Policy uncertainty, especially with respect to trade, may already be having an adverse impact on global growth by constraining investment spending.

POLICY UNCERTAINTY ON THE RISE



Source: Economic Policy Uncertainty Index, latest data as at November 2018

On the upside, a stronger US dollar transfers growth and corporate earnings from the US to the rest of the world. Moreover, if the US Treasury yield curve continues to flatten, it will temper the tightening in global financial conditions implied by further Fed rate hikes. Global investment spending could surprise to the upside in light of corporate sector intentions to boost capex.

Economic outlook: In summary

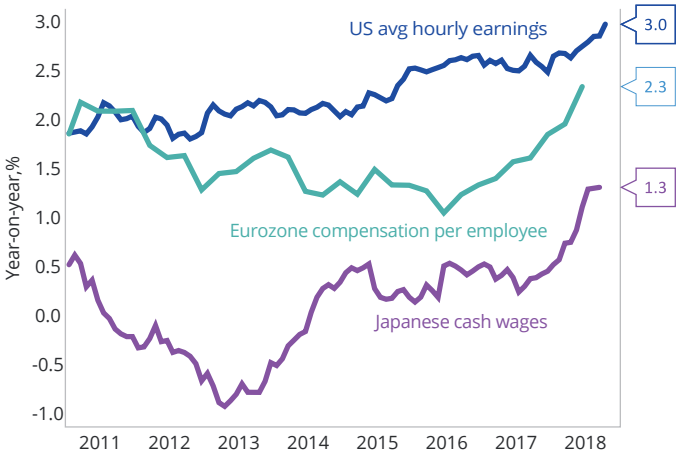
Our baseline is for another year of strong real and nominal global growth in 2019 and that fears of 'late cycle' and recession risk are premature. Nonetheless, we are past the peak in growth and corporate earnings unless productivity trends improve or there is additional policy stimulus. Risks are tilted to the downside from a sharper-than-forecast slowdown in China and an escalation in trade conflicts.

Inflation & interest rates – the only way is up

Low inflation and even deflation is a feature of the long and slow recovery from financial crises. Extrapolating very low inflation of the post global financial crisis era is making central banks cautious in removing monetary stimulus and investors complacent of upside inflation risks at this stage of the economic cycle.

Claims of 'the death of the Phillips curve' are premature, with wage inflation in Europe and Japan, as well as the US, accelerating as the unemployment rate falls to pre-financial crisis lows. Monetary policy across the major economies remains accommodative despite shrinking spare capacity and rising inflation pressures. Moreover, popular demand for higher minimum wages and the end of fiscal austerity, as well as trade protectionism, add inflationary fuel to the fire.

WAGE GROWTH ON AN UPWARD TREND



Source: US Bureau of Labour Statistics, Japanese Ministry or Labour, ECB, latest data as at November 2018

A data-dependent Fed

Shrinking output gaps and rising wages will encourage central banks to 'normalise' monetary policy. If the incoming data confirms that the US economy is operating above potential and unemployment is posting new historic lows, the Fed will continue to reduce the size of its balance sheet and raise rates. Interest rate futures currently imply that the Fed hiking cycle will end next year at around 2.75%, implying just one rate hike in 2019 in addition to a 0.25% increase at its last meeting in 2018.

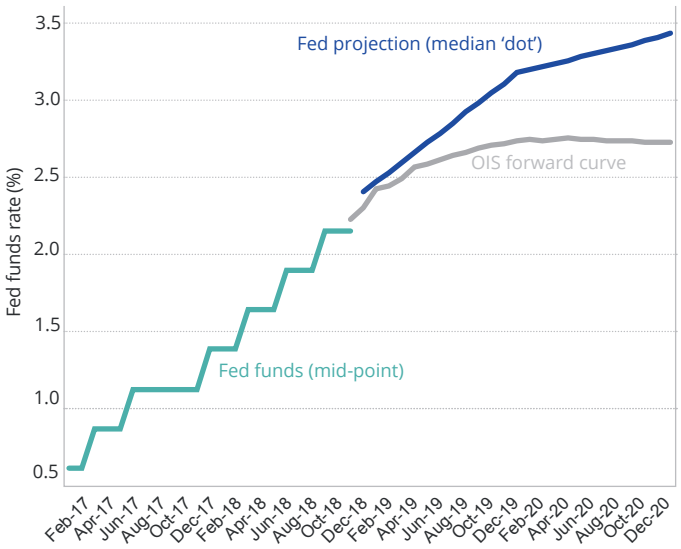
In our view, the Fed is more likely to hike rates three times next year rather than once, in light of another year of above-trend economic growth and rising wage and price inflation pressures. It is likely that during 2019, the 2yr-10yr Treasury curve will be flat with the 10-year Treasury yield peaking around 3.5%.

Inflationary fuel

- Low unemployment and rising wages
- Shrinking spare capacity
- Trade protectionism
- Accommodative financial conditions

"Claims of 'the death of the Phillips curve' are premature, with wage inflation in Europe and Japan, as well as the US, accelerating as the unemployment rate falls to pre-financial crisis lows."

DIVERGENCE BETWEEN FED PROJECTION & MARKET EXPECTATIONS



Source: Federal Reserve; Bloomberg; latest data at 29 November 2018

Europe and Japan playing catch up

ECB forward guidance precludes it from raising interest rates until after the summer of 2019. But if the eurozone continues to expand at a rate closer to 2% than 1%, domestic inflation pressures will build and could lead to a re-pricing of market expectations of the current very flat path of ECB tightening.

Consensus discounts any tightening by the BoJ despite unemployment at a 25-year low, rising wages and worries that negative rates and a flat yield curve pose financial stability risks.

Emerging markets – the worst of times, the best of times

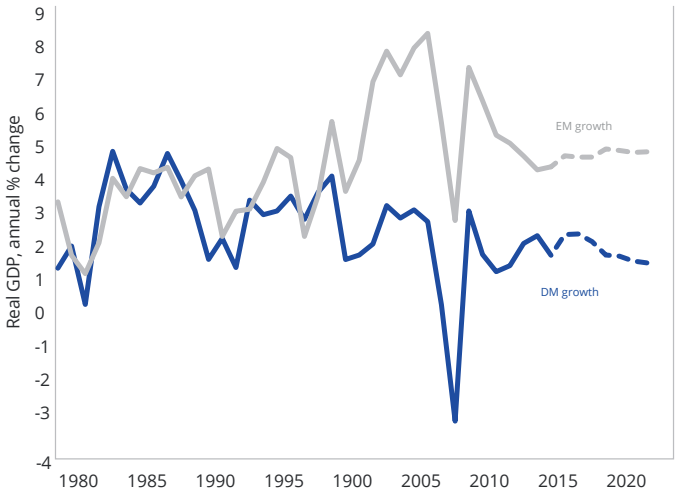
EM economies, especially in Asia, are vulnerable to the backlash against globalisation in the 'West' if it results in shrinking global supply chains and trade.

Moreover, the resilience of EM policy frameworks and balance sheets have been challenged for some countries left exposed by the 'triple whammy' of rising US interest rates, a strengthening US dollar and the impact of QT on capital inflows. But EM assets have re-priced to reflect these risks much more than in developed markets, while the fundamental underpinning of EM growth and investment outperformance over the medium-term remains intact.

EMs benefit from a growing and increasingly affluent population; technological and productivity catch-up; the broadening of trade flows between regional markets; and the greater depth and sophistication of domestic financial markets.

Playing the EM trade

EM GROWTH ADVANTAGE OVER DM FORECAST TO INCREASE



Source: International Monetary Fund World Economic Outlook forecasts, October 2018

"The rising share of EM in the global economy and financial assets is a secular trend that investors should not ignore."

The challenge for investors is accessing the return and diversification benefits from EM assets in a manner that limits the periodic drawdowns and volatility associated with the asset class.

Too few so-called 'global strategies' genuinely integrate the investment opportunities in EM into the investment process. The differentiation (and diversification benefits) across EM in terms of economic and political fundamentals is much greater than in developed markets.

In our view, strategies that are nimble and able to position on the short as well as long side and are less constrained by benchmarks (even China, the world's third-largest bond market, is not yet represented in all major fixed-income indices) in their investment process are best placed to exploit the opportunities offered by EM.

Credit pickers' delight

In the near-term, the growth outlook for EM remains positive and default rates are expected to remain low.

Tighter external financing conditions are a headwind, but growth in Latin America is set to accelerate (led by Brazil). Moreover, African and Middle Eastern economies are still benefiting from a modest recovery, while Asia is forecast to expand at around 6%. Credit valuations are attractive relative to similarly rated developed market credits and 'credit pickers' can fish in a much deeper pool of distressed and performing assets that potentially offer significant capital appreciation, as well as low correlation with US rates and the US dollar.

EM currencies are in aggregate 'cheap' by historic standards although in the near-term much will depend on the evolution of the US dollar.

EM: 10-second summary

- Fundamental underpinning of EM growth and investment outperformance over the medium-term remains intact
- EM assets attractively valued versus developed market counterparts
- Diverse universe of country and idiosyncratic risks that offer opportunities for credit pickers

Not yet end of cycle

In 2019, the current US economic expansion will be the longest on record and as time passes, anticipating the turn in the credit cycle becomes of ever greater importance for all investors.

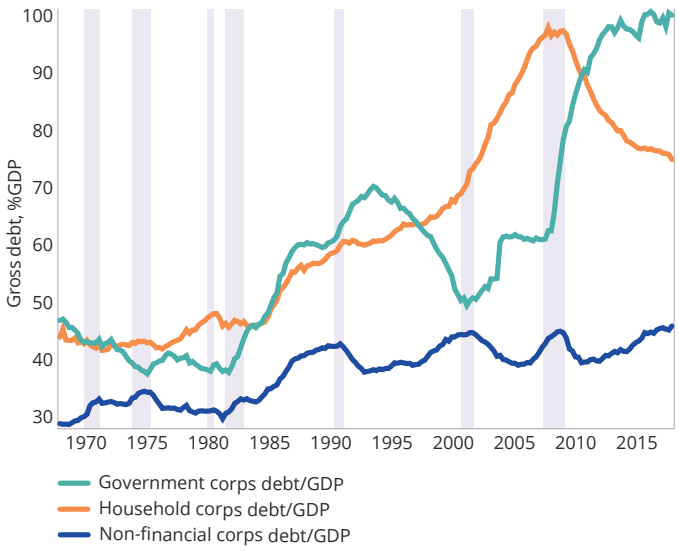
A turn in the credit cycle typically precedes the onset of recession as credit conditions tighten, spreads widen and defaults pick-up, while equity markets enjoy a late cycle 'last hurrah'. Timing the turn in the cycle is notoriously difficult, arguably made even more so by the distortions created by the extraordinary and unconventional monetary policies of the post-financial crisis era.

The two conditions

Two conditions need to be present for a decisive downturn in the credit and default cycle: a **pending recession** and the **misallocation of capital**, as happened in the 'dot.com' and telecom booms in the late 1990s, and the mortgage-backed securities blow-up in the mid-2000s.

In our view, neither condition is currently met in the US and other major developed economies. Late-cycle excesses typically show up in the emergence of financial imbalances in the private sector – exuberant CEOs spending more than income in the late 1990s and excessive household borrowing prior to the 2007-09 financial crisis – and are currently not present in the US or other major developed economies.

US DEBT TO GDP BY SECTOR



Source: US Bureau of Economic Analysis (BEA), Federal Reserve Q2 2018
Note: Shaded columns denote NBER-dated US recessions

In contrast to the private sector, the US federal government is running a large deficit despite above-trend growth. The budget deficit is unlikely to be the catalyst for an economic downturn but will make it much harder for fiscal policy to respond in a counter-cyclical manner when the economy eventually slows.

Late-cycle clues

There are, however, signs of 'late cycle behaviour' in US leveraged loan markets, with leveraged buy-outs and merger and acquisition activity on the rise and the erosion of protections for lenders.

In contrast to the high yield market that has shrunk in recent years, the leveraged loan market is growing fast and stands at more than USD1.3 trillion – as large as the high yield bond market.

Strong investor demand for floating rate and secured credit is being matched by supply from borrowers attracted by the additional flexibility afforded by the loan market. Another 100bps of Fed rate hikes may trigger some stress among 'B' rated issuers (some USD300 billion) if accompanied by weaker earnings, but in our view does not pose a systemic threat to broader credit markets and the economy. In contrast to the financial crisis, investors are not leveraged and reliant on short-term funding, while banks' loan exposure is much lower.

Fallen angels

Corporate leverage more generally is relatively high in the US but has recently stabilised. In the QE-era, investment grade publicly listed corporations have used cheap debt to fund share buybacks rather than capex and acquisitions.

The rise in 'BBB'-rated debt is a key vulnerability in the next downturn phase of the credit cycle. BBB non-financial debt stands at around USD2.5 trillion – more than half the US investment grade market – compared to USD1 trillion at the end of 2010. The quantum of 'fallen angel' debt in the next downturn could be as much as USD300 billion, creating severe indigestion in the high yield market. Sectors that have accumulated the most debt in recent years would be the most vulnerable to downgrade risk: energy, healthcare, technology and media.

European risk/reward

Europe is lagging the US in the credit and business cycle. Despite the ECB buying corporate bonds and adopting negative interest rates in the last few years, European companies have not been tempted by record-low yields to increase borrowing, and leverage has actually declined.

The threat to European credit investors does not emanate from the deterioration in corporate credit fundamentals, but from a China-led downturn in the European economic and corporate earnings outlook, and, closer to home, Italy sovereign credit risk[1].

We expect some narrowing of Italian government bond (BTP) spreads as investors conclude that the stand-off between the European Commission and the populist Italian government over its 2019 Budget plans is not a prelude to an 'Italexit' (Italy abandoning the euro and leaving the EU) and the public debt-to-GDP ratio is on a stable path.

Growth may not be strong enough in 2019 to drive global equity markets meaningfully higher, but it is good enough to keep default rates low and for credit to generate positive, albeit modest, returns.

European credit, in particular, fully prices lower growth as well as Italian political risk, while the challenge for US credit is increasing FX-hedging costs for international investors to fund dollar assets allied with a flattening US yield curve.

Going into 2019, in our view European credit offers an attractive risk / reward profile but greater dispersion and M&A activity means US credit offers greater alpha generation opportunities.

The case for cocos

The recovery of the European banking sector is a structural investment opportunity that remains in place despite disappointing growth and Italian political risk.

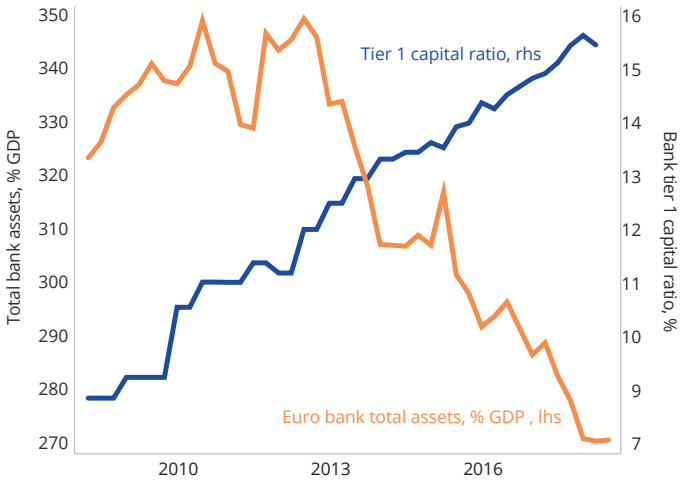
European bank healing and disintermediation can be accessed in a number of ways that best reflect investors' risk appetite and liquidity profile.

The latest European Banking Authority (EBA) stress tests demonstrated the extent of banks' improved credit fundamentals and resilience to adverse shocks, including the major Italian banks.

European bank debt, especially convertible contingent bonds (cocos) offer mid-to-high single-digit yields and meaningful spread pick-up over similarly rated non-financial corporate debt. The healing of European banks goes hand in hand with a secular trend of disintermediation that provides an investment opportunity for investors able to forgo liquidity to directly provide flexible capital to small and medium-sized business.

"Anticipating the turn in the credit cycle becomes of ever greater importance for all investors."

EUROPEAN BANKS - SHRINKING BALANCE SHEET AND RISING CAPITAL



Source: ECB (European Central Bank) Eurostat Q1 2018, Q2 2018

1 Italian issuers account for around 5% of outstanding euro investment grade corporate debt and 15% of the high yield market.

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. 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 credit 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.