Asset Allocation Navigator

First quarter 2019

Risk assets were 'over-sold' into year-end as investors panicked that the global economy was on the brink of recession. As in early 2016, peak pessimism on global growth coincided with the US Federal Reserve (Fed) signalling a delay in further rate hikes and policy stimulus by Beijing. Risk premiums are still relatively elevated in our opinion, despite the retracement of much of the December sell-off in the first weeks of January. But for the rally in risk markets to be sustained, the flow of corporate earnings and economic data must imply stabilisation. And an escalation, rather than the expected truce, in the US-Sino trade war remains a key downside risk. The deceleration in growth expectations is more pronounced for developed than emerging economies and with the Fed on 'pause', the backdrop is supportive for emerging market (EM) assets to outperform. In our multi-asset credit strategies, exposure to EM debt has been raised, notably local currency debt.

Patience, truce and stabilisation

The catalyst for the sharp sell-off in growth-sensitive risk assets at the end of last year was a perfect storm of falling oil prices, rising worries of a China 'hard landing' – exacerbated by fears of an escalation in US-Sino trade war – and a Fed that appeared deaf to these concerns. The Fed has since shifted to 'patience' on interest rates – a pause through the first half of the year – and potential 'flexibility' on the unwind of its balance sheet. It is likely, but far from certain, that President Trump will call a truce on the trade war as he seeks to shore up US equity markets – his barometer of economic success – and positions for his re-election campaign next year. Regular, albeit piecemeal, policy easing announcements by Beijing signal an important shift from deleveraging to growth stabilisation.

Equity markets retraced roughly half of their drawdown in the final quarter of last year, credit markets less so, and core government bond yields remain near their 12-month lows. Most BlueBay strategies are moderately positioned pro-growth, with asset risk premiums still discounting elevated recession risk. In multi-asset credit strategies, cash and European bank and peripheral risk have been paired to fund an increased allocation to EM debt.

In our view, investors remain too pessimistic on the outlook for global growth. Employment and wages are rising in Europe and Japan, as well as the US; investment and capex intentions remain solid, albeit trade tensions are weighing negatively on business sentiment.

But for the risk rally to be sustained into and through the second quarter, more evidence of a stabilisation in global growth is required from corporate earnings and guidance, as well as the flow of economic data. European economic data continues to disappoint; the prolonged government shutdown will have a negative, albeit largely transitory impact on US growth and it is too soon for the Chinese economy to respond to recent policy easing.

MARKET INSIGHT

David Riley
Chief Investment Strategist
January 2019

TACTICAL ASSET CLASS PERSPECTIVE

(3–6 month outlook)[1]

Global assets

	-		Neutral		+
Equity				■	
Credit			■		
EMD		→	→	■	
USD rates		■			
EUR rates			■		
Cash		■	←		

Credit

	-		Neutral		+
US IG		■			
EU IG				■	
EU HY				■	
US HY		■			
Loans			■		
Converts			■		

Emerging market debt

	-		Neutral		+
EMD Sov				■	
EMD Corp		■			
EMD Local		→	→	■	

Credit

In contrast to early 2018 when developed market (DM) credit spreads were at or near cycle tights, they are currently at levels consistent with sub-par growth and moderately higher default rates. Break-evens on spreads (the increase in spreads required to wipe-out return from carry) will only be breached if markets anticipate recession in the near-term. We currently favour euro over US credit, especially in high yield, in light of recent performance and relative valuations (by historical standards euro credit spreads are 'cheap' to US). We are underweight industrial cyclicals, including the auto sector, and have a bias to more liquid and better quality securities. Similarly, in CLOs we have shifted exposure from 'B' to 'BB/BBB'-rated tranches and higher.

We expect the European Central Bank to announce an extension of liquidity financing facilities for banks at its March meeting that will be supportive of European bank debt, which remains 'over-weight' in our multi-asset credit (MAC) strategies, albeit with a bias to the strongest 'names'.

Emerging market debt

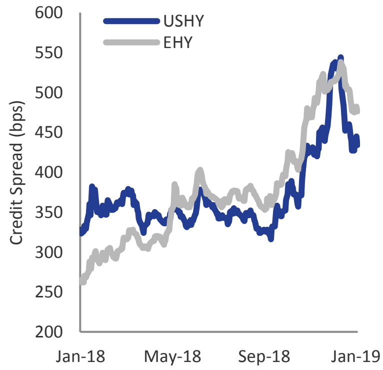
Lower growth was more fully reflected in the valuation of EM rather than DM assets, and along with light investor positioning, EM assets outperformed during the sell-off and at the start of the year. Assuming that China avoids a 'hard landing' and there is no escalation in the Sino-US trade war, the growth gap between EM and DM will widen this year. With the Fed on 'pause' through the first half of the year, the backdrop for continued EM outperformance is in place. EM currencies are fundamentally 'cheap' following large depreciations in 2018, while nominal and real (inflation-adjusted) local bond yields remain high in several countries. We have increased exposure to EM local currency debt and in 'hard currency' credit prefer sovereign over corporate due to relative valuations, despite improving corporate fundamentals and low default rate.

Rates

High-grade government bonds offered a partial hedge against the drawdown in risk markets, with 10-year US Treasury and Bund yields falling by 60bps and 30bps, respectively, between early November and January. The sharp fall in yields reflected a dramatic re-pricing of market expectations for future central bank rates. The first rate hike by the ECB is expected by markets to be in March/April 2020 at the earliest. With eurozone economic data likely to disappoint in the first quarter, ECB forward guidance is likely to become more 'dovish' with an extension of its long-term refinancing facilities for European banks.

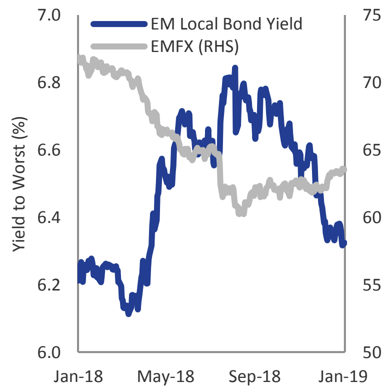
The shift in market expectations for Fed hikes is even greater (and more important for global markets) than for the ECB. Forward rates (and the Treasury curve) imply that the Fed rate hiking cycle has peaked at 2.25%–2.50% and that the Fed is likely to cut rates in 2020. The outlook for US rates is asymmetric – it is very unlikely, in our opinion, that the Fed will cut rates in 2019, while the likelihood of one or two more hikes is much greater than implied by the market consensus. We expect the Fed to resume hiking rates in June and again towards the end of the year as the economy expands above potential and unemployment continues to fall.

FIG 1: US & EURO HY SPREADS



Source: BoAML, as at 25 January 2019

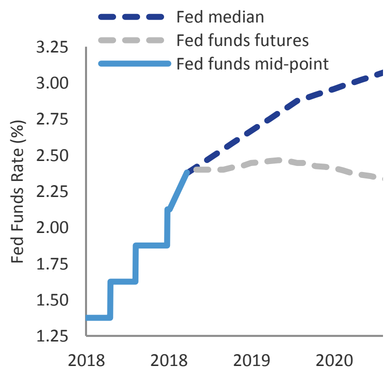
FIG 2: EM LOCAL BOND YIELD & EM CURRENCY INDEX



Source: JP Morgan; as at 29 January 2019

Note: yield on JP Morgan GBI-EM Broad Diversified index and JP Morgan Emerging Market Currency Index

FIG 3: FOMC RATE PROJECTION & FED FUTURES CURVE



Source: Macrobond; Bloomberg; FOMC median 'dots' (19 December 2018 meeting); latest data at 29 January 2019

Note: 1 'Tactical asset class perspective' summarises the broad short-term tactical asset allocation views of BlueBay's Chief Investment Strategist and 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 (4th Quarter 2018 published in October 2018).