Asset Allocation Navigator

Second quarter 2019

Nervous markets are torn between the dovish 'pivot' by global central banks and the 'pervasive uncertainty' on the outlook for global growth. Assets sensitive to central bank liquidity – core government bonds, higher-quality corporate credit and emerging market (EM) debt – have outperformed more growth-sensitive low-rated bonds, European cyclical assets and EM currencies. We expect global growth to stabilise in the second quarter and to pick-up into the second half of the year, allowing the laggards in the risk rally to catch up and core rates to drift higher. In the current low and stable rates environment, we are focused on extracting carry without taking excessive risk. In the meantime, we patiently await the economic data and corporate earnings guidance to confirm our thesis that global growth has troughed.

Great time to be patient

The sell-off in risk assets at the end of 2018 was in part due to a Federal Reserve (Fed) seemingly on autopilot in shrinking its balance sheet and hiking rates. The 'pivot' to an early end to quantitative tightening and a 'data dependent' stance on rates has underpinned the subsequent rally in global risk markets and falling bond yields.

But the first-quarter rally in risk assets belies a continuing worry prevalent in fixed income markets that the downturn in global growth in the second half of last year will persist and deepen. But a simultaneous rally in bond and equity markets is unlikely to continue through the second quarter – either growth fears will ease and bond yields will move higher or equity markets will heed the growth warning from falling bond yields.

The resilience of the US dollar, despite the Fed's dovish pivot, reflects confidence that US growth will outperform – a view we share – and worries that Europe is on the brink of recession. But like the Fed, investors should be patient. Most of the slowdown in Europe was imported from China and the decline in global trade. With policy stimulus from Beijing set to stabilise Chinese growth, solid domestic demand and an ECB determined to keep financial conditions easy, we believe the economic gloom hanging over Europe is excessive.

The US presidential election campaign is effectively underway, and President Trump wants a trade deal 'win' with China that will be positive for Europe and EM, despite the lingering threat of tariffs on European autos. A 'crash out' Brexit remains a tail risk but a prolonged extension and 'soft Brexit' is still the most likely outcome. Populist gains in the European Parliament election in May will generate political noise, but the market impact will be minor. Focus instead on the flow of economic data and corporate earnings.

With rates anchored by dovish central banks and global growth set to stabilise, we favour European bank and EM debt in our multi-asset strategies. But be selective and patient in adding risk until the pervasive uncertainty over global growth fades.

MARKET INSIGHT

David Riley
Chief Investment Strategist
April 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

Falling bond yields and credit spreads powered strong first quarter total returns across credit. With core interest rates staying lower for longer and economic growth good enough for default rates to remain benign, we expect credit to continue to generate positive returns. Lower rated more growth-sensitive cyclical credit has lagged the broader rally, creating opportunities to selectively mine pockets of value to supplement carry. Assuming that global and European growth has troughed, in our opinion European credit will likely make-up for its underperformance so far this year relative to US credit.

It is likely that the ECB will make the pricing of the additional bank liquidity facilities (TLTRO-III) more attractive and may introduce interest rate 'tiering' on bank deposits, easing the headwind for European banks from negative rates. European bank debt remains 'overweight' in our multi-asset credit (MAC) strategies. European peripheral sovereign credit also offers good value in our opinion.

Emerging market debt

EM 'hard currency' sovereign and corporate debt is benefiting from the dovish pivot by the Fed and attractive valuations relative to similarly rated developed market credit. Investors remain cautious in light of the turbulence and drawdowns that characterised EM assets in 2018. But investor positioning is much less 'crowded', valuations are more attractive and fundamentals are improving (declining corporate default rates and improving external balances). Along with a Fed on hold at least until the end of the year, a repeat of 2018 is unlikely in our opinion and our MAC strategies are 'overweight' EM debt.

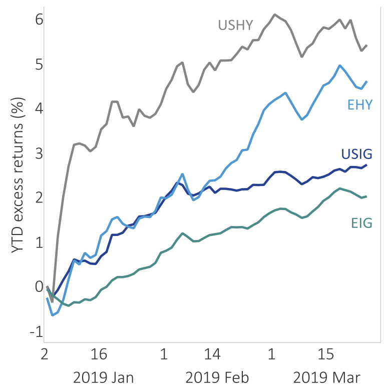
EM local currency debt has so far lagged the performance of EM credit despite 'cheap' currencies and relatively high nominal and real (inflation-adjusted) local bond yields. In our view, as global growth concerns dissipate and investors' bias for US assets moderate, EM currencies and local debt offers meaningful upside potential.

Rates

A defining feature of the first quarter and outlook for the rest of the year is the dramatic shift lower in market expectations for policy rates and partial inversion of the US Treasury curve. Critically, the Fed pivoted from signalling three rate hikes in 2019 to none and announcing the end of 'quantitative tightening' (the shrinking of the Fed's balance sheet). But in our view, rates markets have overshot on pricing cuts in Fed policy rates starting this year. Rising employment, support consumption and recession risk is much lower than implied by the Treasury curve. As wage growth gradually picks-up and approaches 4% in the latter part of the year, there will be a re-rating of the outlook for Fed rates.

In Europe, the sharp slowdown in growth and fall in inflation expectations, along with the risk of a disorderly 'Brexit', has resulted in the German Bund yield falling back into negative territory and a rise in negative yielding debt. But as 'pervasive uncertainty' and excessive 'euro gloom' diminishes, the bias will be for core rates to drift higher.

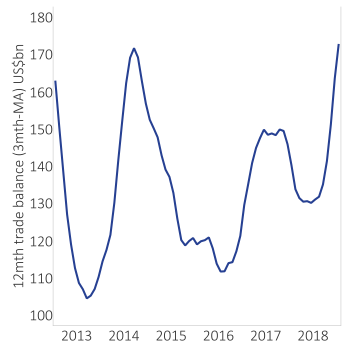
FIG 1: YTD EXCESS RETURNS



Source: Barclays Bloomberg; latest data at 26 March 2019

Note: excess return is total return less return from underlying risk-free bond.

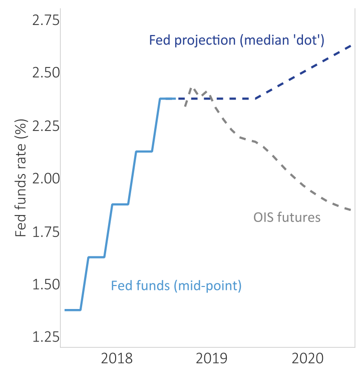
FIG 2: EM TRADE BALANCE



Source: BlueBay Asset Mangement; latest monthly data for 2019

Note: rolling 12-month trade balance of countries in JP Morgan GBI-EM Global Diversified index

FIG 3: FOMC RATE PROJECTION & MARKET IMPLIED CURVE



Source: Bloomberg; Macrobond as at 22 March 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 (1st Quarter 2019 published in January 2019).