Insights

Asset Allocation Navigator

Third quarter 2016

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Brexit – the UK's referendum vote to leave the EU – is a local difficulty but a global event for interest rates, further fuelling the search for yield. In our view an environment of lower for longer interest rates and positive, albeit mediocre, global economic growth and corporate earnings is favourable for positive-yielding assets, notably credit and emerging market debt. The search for yield is likely to continue to dominate markets, but the possibility of further episodes of volatility should not be ignored. US short-term interest rates are vulnerable to Federal Reserve rate hikes being priced back in, but not sufficiently to drive longer-term yields violently higher. We are fully invested, but our focus is on credit rather than term premium, with a bias for higher-quality yielding assets and nimble portfolios.

Beyond Brexit

The UK economy is likely to stagnate later this year but, despite the Brexit shock, the cyclical upturn in the eurozone economy remains in place supported by the European Central Bank's (ECB) monetary easing bias. Of much greater importance from a global growth perspective is the stabilisation of China and emerging market growth and the rebound in the US economy that has, for now at least, dispelled the global and US recession fears that hung over markets in the first half of the year.

We believe China's economy is currently on a soft landing path and the outflow of private capital that undermined confidence in the ability of the authorities to manage the currency earlier this year has moderated. Nonetheless, the Chinese currency is steadily depreciating and, towards the end of the year, 'China risk' may return as the effect of fiscal and credit easing begins to fade.

The US economy is near full employment and domestic inflation will continue to gradually drift higher. But, in a low global growth and yield environment, the ability of the US Federal Reserve (Fed) to raise interest rates will be constrained by a stronger dollar. The net effect is a Fed that will struggle to raise rates by more than once this year and a US dollar that will remain range bound.

The global economy and financial markets are in a disinflationary equilibrium that is vulnerable to the failure to successfully resolve concerns around European (especially Italian) banks, disappointing US corporate earnings, renewed oil price weakness and political risk. Yet, in the absence of unpleasant surprises, it is an equilibrium that, in our opinion, justifies putting cash to work and for risk assets to perform.

Global assets

In much of Europe and Japan, swathes of government bonds trade with a negative yield. In our opinion, There Is No Alternative – TINA – for investors but to actively

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				■	

Global Asset Management

seek yield beyond traditional fixed income in their home markets. Monetary policies may be increasingly reckless, but for now at least investors' search for yield is defensive. US dollar assets – Treasury securities, credit and emerging market debt – are the principal beneficiaries of the flight from negative rates in Europe and Japan. Emerging market sovereign debt and US investment grade credit offer a positive yield with moderate risk, a much more attractive investment proposition than the certain loss of negative-yielding 'safe' debt.

In our multi-asset credit strategies we have increased exposure to emerging market debt (EMD) financed from reduced cash balances. Emerging markets have already performed strongly this year as has developed market credit, especially US high yield, but we think that EMD is more likely to outperform in the future. Despite the recent rally, emerging market assets remain cheap relative to developed market assets and, following significant outflows from the asset class in recent years, investors are under invested. Our bias is therefore to take profit in global high yield and gradually rotate exposure into emerging markets over the coming quarter.

Credit

The rebound in commodity prices, along with the ECB's corporate sector purchase programme and the reach for yield, has powered a decline in global credit spreads to lows for the year. We think there is scope for further spread tightening, especially in European high yield and US investment grade. The steady rise in the US high yield default rate that extends beyond the energy sector and the record low all-in yield on European corporate investment grade limit the room for further meaningful spread compression in either asset class in our opinion.

We believe that improving credit fundamentals and current valuations render European bank capital an attractive investment opportunity especially if, as we expect, there is a successful resolution of the legacy of non-performing loans that has plagued the Italian bank sector for several years. A capital injection of c.€40 billion (2% of GDP) should be sufficient to deal with non-performing loans (net of provisions) of some €200 billion. We think that European policy makers and banks will craft a solution that injects new capital into the banks without 'bail-in' of subordinated debt, much of it held by local retail investors, so as to not threaten the position of reformist Italian PM Renzi.

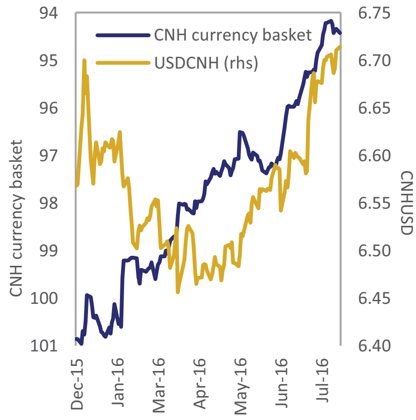
Emerging market debt

The gap between interest rates in emerging and developing markets is significant, especially in real terms, and there is room for central banks to cut rates. We are overweight local bond markets though the scope for currency gains will be limited by central banks exploiting the opportunity to replenish FX reserves in the face of any currency strength. We assess that 'hard currency' sovereign credit should remain well supported by limited supply and strong demand for US dollar-denominated spread product from international investors. While we are currently defensively positioned with respect to emerging markets corporate credit, it is likely that we will add exposure as we rotate from global leveraged finance. There are significant political risks in emerging markets – as the recent attempted coup in Turkey demonstrates – but in our opinion these are more appropriately priced than in developed market assets. Moreover, the growth outlook across emerging markets is starting to improve as economies adjust to lower commodity prices and slower China growth.

Rates

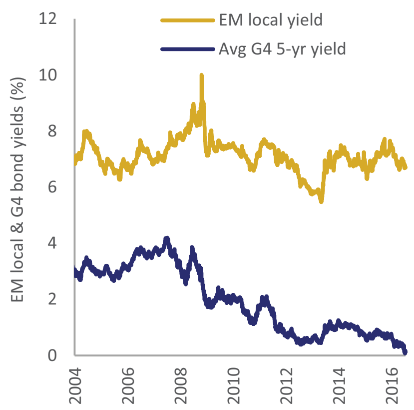
We have recently cut-back on euro duration in a number of strategies following the extension of negative yields along core yield curves in Europe. Nonetheless, we believe that the shortage of safe assets and quantitative easing will continue to keep European rates well anchored. However, we do think that US rates, especially at the very short end, are likely to move meaningfully higher as the market begins to price back in the prospect of at least one Fed rate hike before year-end. US Treasury yields will also likely drift higher from current levels, but in our view the demand for safe yield will ensure that any move is moderate and gradual.

Fig. 1 CNH/USD and CNH basket



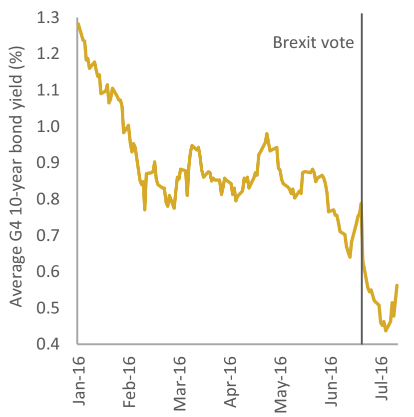
Source: Bloomberg, as at 15 July 2016

Fig. 2 EM DM yield gap



Source: Macrobond, JP Morgan, as at 15 July 2016
Note: simple average G4 5-year bond yield; EM local yield is GBI-EM yield to maturity

Fig. 3 Lower G4 bond yields post-Brexit



Source: Macrobond; data as at 14 July 2016
Note: simple average yield on US, German, Japanese and UK 10-year government bonds

Note:

1 'Tactical asset class perspective' summarises the broad short-term tactical asset allocation views of BlueBay's Asset Allocation Committee. The solid boxes reflect weights across asset and sub-asset classes (these 'weights' are indicative and do not relate to specific funds). The arrows indicate a shift in our tactical asset allocation since the previous Asset Allocation Navigator (Second Quarter 2016 published in May 2016).

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