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European government bond yields fell after dovish central bank comments
Brexit remains a potential source of volatility
Italy looks like an accident waiting to happen

European government bond yields fell materially during the quarter, reflecting easier monetary policy expectations, Brexit uncertainty and a weakening global economic outlook. The yield on 10-year German government bunds continued to fall deeper into negative territory, supporting Italian bonds in particular as investors searched for yield. The French 10-year government yield also turned negative for the first time. Additionally, European breakeven inflation continued to fall, with euro (EUR) five-year/five-year forward breakevens reaching all-time lows during the quarter.

Against a backdrop of weaker economic growth and a sharp fall in inflation expectations, the European Central Bank (ECB) pushed back rate guidance to keep interest rates at current levels until the first half of 2020, extending its previous timeframe of “at least through the end of 2019”. Additionally, growth forecasts for both 2020 and 2021 were revised lower to 1.4%. ECB President Mario Draghi also surprised markets with his remarks at the ECB Forum in Sintra, which pointed to another round of easing from the central bank. The implementation is still uncertain, and former IMF Managing Director Christine Lagarde will be running the institution from November onwards, but the market started pricing in both quantitative easing and rate cuts.

Looking ahead, potential volatility could arise from the UK where Boris Johnson, the new prime minister, will attempt a definitive exit on 31 October. As such, we remain cautious on the outlook for the UK. Elsewhere, Italian government bonds have benefitted since the ECB announced that new easing measures could be on the way and the yield on the Italian 10-year bond has fallen back to pre-budget crisis levels. The spread between the Italian and German 10-year bond narrowed by about 13bps during the quarter. However, Italy remains a source of concern for us and we believe the country remains an accident waiting to happen. Italy’s debt, currently above 130% of GDP, is now larger than Greece’s was before its own crisis began.

Figure 1: Spread between Italian and German 10-year government bonds has narrowed (bp)

Source: Bloomberg. As at 1 July 2019.
US GOVERNMENT BONDS

A PRECAUTIONARY CUT OR AN EXTENDED EASING CYCLE?

Isobel Lee
Head of Global Fixed Income Bonds

- The Federal Reserve (Fed) is positioning to ease rates in coming quarters
- Markets have moved to anticipate a deeper easing cycle than currently indicated by the Fed
- The lack of inflation provides flexibility, but markets may end up disappointed

The US Treasury curve shifted lower and steepened in Q2, with 2-year Treasury yields falling by 51bp, 10-year yields falling by 40bp and 30-year yields falling by 29bp. With Q1 GDP expanding by an annualised 3.1%, unemployment at a 50-year low and wages at last starting to gain traction, it is difficult in isolation to see why US bond yields declined so dramatically. The drop in US yields, however, needs to be taken in a global context. Over the quarter the aggregate value of outstanding debt which trades with a negative yield accelerated sharply, reaching a new high of $13 trillion (see Figure 2). In a world of negative yields, the high nominal yields available in the US offer relative value and with markets anticipating a US easing cycle, Treasury yields plunged.

The Federal Open Markets Committee (FOMC) at its June meeting reinforced market sentiment, with James Bullard voting for a 25bp rate cut at the meeting. Minutes also pointed to an increasingly uncertain outlook, with the need for patience replaced by a comment that the Committee would act as appropriate to sustain the expansion.

The persistent lack of inflationary pressure increases policy flexibility and markets, sensing a change of direction, have moved to anticipate a significant easing cycle. Although the ‘dot plot’, which the FOMC uses to communicate its interest rate expectations to the market, declined once again, it remained materially different to market pricing – showing the FOMC continues to forecast higher rates in future than the market expects.

For investors, the momentum in market action has to be weighed against the potential that the Fed will ultimately deliver only a moderate easing cycle unless there is a more meaningful deterioration in the economic backdrop. Risk assets appear to be anticipating that central bank easing will be sufficient to stabilise the growth outlook. This further complicates the Fed’s position, as it will potentially be reducing interest rates with a backdrop of the S&P 500 Index breaking to new record highs.

This means that over the coming quarters we are likely to face a complex interplay between bond, equity and credit markets as the economic fundamentals evolve and become clearer. This will of course be further complicated by politics, with President Trump combining social media and US trade policy into a potent and highly disruptive weapon with which to achieve his goals. We closed our short duration position last year with 10-year yields in excess of 3% and have thus fully participated in the strong gains since that point. For now, we remain close to benchmark and await confirmation that either the market or the economy is losing momentum before taking more significant active duration positions.

Figure 2: A global shift to negative yields dragged US 10-year Treasury yields downwards

We retain a cautious stance on the UK given the wide array of potential outcomes that are possible before the end of 2019

DAVID HOOKER
TOO MANY POSSIBILITIES CREATE A DIFFICULT INVESTMENT BACKDROP

David Hooker
Senior Portfolio Manager
Fixed Income

• Gilt yields have dropped, driven by both global and domestic factors
• Bank of England policy likely to be dominated by Brexit through remainder of 2019
• We retain a cautious outlook given the high degree of uncertainty

With a backdrop of intense political uncertainty, the Bank of England’s Monetary Policy Committee (MPC) highlighted in its June minutes that the downside risks to growth had increased and that the perceived likelihood of a no-deal Brexit had risen. Boris Johnson has replaced Theresa May as prime minister, and he has committed to the UK leaving the EU on 31 October regardless of any deal being struck. This creates a highly uncertain environment for the rest of 2019, compounded by a slowing global economy and unpredictable US trade policy. Bonds rallied across the world over the quarter and, given the additional domestic concerns, it was unsurprising that gilts followed a similar path.

Looking forward, the MPC has noted that the monetary policy response to Brexit will not be automatic, and could be in either direction depending on the impact on demand, supply and the exchange rate. To add to the confusion, economic data is being impacted by stockpiling, which pulled forward production into the first quarter as firms prepared for a potential withdrawal at the end of March. As a result, the Bank of England expects economic growth to be flat in the second quarter, but some forecasters are now expecting the economy to contract. The IHS Market/CIPS manufacturing purchasing manager’s index (PMI) dropped to 48 in June, the lowest level since February 2013, while the construction PMI dropped to 43.1, the worst level since 2009. At this stage it is difficult to pinpoint to what extent this is due to Brexit, the weakening global environment or concerns that a general election could result in a radical Jeremy Corbyn-led government.

We retain a cautious stance on the UK given the wide array of potential outcomes that are possible before the end of 2019. Now that Boris Johnson is UK prime minister, having pledged significant fiscal loosening, increasing spending and cutting taxes, he will need to get past 31 October with government and party still intact. Ultimately, the potential outcomes could be positive or negative for gilt yields, and we believe greater clarity is needed before taking any significant position.

Figure 3: 10-year UK gilt yields versus UK budget balance

Global Investment Grade Credit

Credit Spreads Tighten as Central Banks Ease Economic Worries

Peter Bentley
Deputy Head of Fixed Income and Head of Global Credit

- Central banks offer support for credit
- Carry trades return as bond yields fall
- Summer lull in issuance leave credit tactically well-positioned

Global credit markets saw some volatility in the second quarter, but spreads ultimately ended the period comfortably tighter. Initially, markets carried the positive momentum from the first quarter and sterling credit saw some additional relief after Brexit was extended as far as autumn (and notably, Prime Minister Theresa May’s subsequent resignation did not generally result in outsized volatility).

However, global growth concerns, particularly relating to Europe, continued to be a notable theme. These concerns were exacerbated by escalating global trade tensions. Not only did the US-China spat deepen, via further actions against Huawei, but the US also set its sights against Boeing’s European rival Airbus, threatening tariffs against EU countries that provide subsidies. The US administration’s threat of tariffs against Mexico was a notable contributor of volatility in the European autos sector.

Sentiment, however, improved markedly in June following the dovish turn in central bank rhetoric from both the Fed and the ECB. From the latter, ECB President Draghi unexpectedly pledged

“additional stimulus” if inflation conditions remain stagnant. This even led to some optimism of a return to quantitative easing and even corporate bond purchases. The global market value of negative yielding bonds subsequently breached $13trn for the first time on record.

June subsequently became the busiest month for EUR investment grade issuance since early 2016 (in the period after the ECB’s corporate bond purchase programme was first announced) and the busiest June on record. Sterling corporate issuance was similarly strong – the busiest June since 2007 with sterling remaining competitive as a funding currency relative to the US dollar (USD). USD issuance continued to be quiet relatively to history given less activity from the US financial sector.

Looking ahead, we believe the tactical outlook for global credit looks favourable, particularly in the summer break where primary activity will be due to slow down. Markets will remain buoyed by expected central bank support. The main risks, however, relate to certain economies, particularly Germany. Political concerns around Italy and UK also need to be monitored. A modest long position with an emphasis on bottom-up stock selection will probably be key to outperformance in the current environment.

Figure 4: Global investment grade spreads end Q2 narrower

We believe the tactical outlook for global credit looks favourable, particularly in the summer break where primary activity will be due to slow down.

PETER BENTLEY
THE CARRY TRADE IS BACK

Andrew Catalan
Head of US Long Duration

- Carry trade returns as bond yields fall
- Labour market strength may offer economic support
- Trade tensions remain a concern

US credit markets initially began the second quarter carrying positive momentum from the first quarter, supported by an encouraging earnings season and a notable rise in technical support from Asian accounts. By mid-April, spreads reached their narrowest levels since October 2019, essentially retracing the late 2018 sell-off.

However, the rally ended in May, mainly due to an escalation of global trade tensions. Negotiations with China failed to reach a breakthrough and the US administration prevented American companies from providing component parts to Chinese global technology company Huawei. Tensions with Europe also resurfaced as with the administration proposing additional tariffs to countries subsidizing Europe’s Airbus. The US also announced an escalating scale of tariffs against Mexico relating to illegal immigration.

Sentiment nonetheless improved in June, and markets reversed the widening seen in May. The main factor was a decidedly dovish tilt from global central banks, including the Fed, which prompted markets to price in a 100% probability of a Fed rate cut in July. Markets also saw some relief on the trade front with something of a truce agreed with China for the time being and a deal with Mexico preventing further tariffs.

Looking ahead, credit markets are likely to be well-supported by accommodative monetary policy and low supply over the summer. With a record $13tn of global debt in negative-yielding territory globally, US market yields look relatively attractive (even accepting that Treasury yields have also trended down). The ‘carry trade’ is therefore back, and is likely to support US credit in particular. The US jobs market also continues to look relatively robust, implying the US consumer may offer some economic support. Caution is nonetheless required, however, given the potential for a further escalation of trade tensions. In the current environment, we believe an attractive strategy is a modestly long credit risk position with an emphasis on the most attractive bottom-up stock selection opportunities.

Figure 5: Low bond yields support US investment grade carry trade

Source: Bloomberg. As at June 30 2019.
Emerging markets are currently pulled by two conflicting yet moderating tensions. On one side is a softening growth backdrop, and on the other side is the global shift back toward monetary easing and a return to the search for yield.

Growth has been moderating across the emerging market complex, although this decline has yet to become a meaningful downturn. The slowdown is broad-based in nature, and spread across a number of countries and indicators including exports, investment and private consumption. The ongoing trade tensions between the US and China also remain an impediment to future emerging market growth prospects. While tensions have somewhat eased, the trade outlook remains highly unpredictable and thus the extent to which trade flows and business sentiment will be impacted remains unknown.

Meanwhile, in development markets, a combination of growth concerns and disinflationary pressures have led to dramatic about-turns in Fed and ECB monetary policies. This has resulted in dovish revisions to developed market policy rates, which in turn has opened up more space for emerging market policymakers to ease. The looser developed market monetary outlook not only provides scope for emerging market central banks to cut in sync, but also entices bond portfolio flows back to emerging market debt as investors once again seek out yield.

A return to policy easing might also give a boost to emerging market GDP over the next 12 months, although there is a risk that it ultimately proves more supportive for asset prices rather than underlying real economic growth.

Looking ahead, positive catalysts to emerging market debt performance may come from weaker USD performance on the back of a return to Fed easing, the growth slowdown remaining moderate versus something more severe, and an easing of trade tensions between the US and China. Conversely, negative catalysts include an outright collapse in global growth, an acceleration of trade tensions, USD strengthening or developed market monetary easing being priced out (perhaps due to upside surprises to developed market growth or inflation data – with long-end Treasury and bund yield curves selling off).
With increasingly accommodative central bank policy expected in the coming months, the hunt for yield has begun to resurface among investors.

RANBIR SINGH LAKHPURI
BIFURCATION EMERGES AMID OPPORTUNISTIC PRIMARY TRANSACTIONS

Ranbir Singh Lakhpuri
Senior Portfolio Manager, Secured Finance

- Primary activity focused on opportunistic transactions
- Investors showing more credit discipline given difficult syndications
- In our view, the macro and political backdrop remains challenging

After a disappointing start to the second quarter in April, European leveraged loan new issue supply picked up. May was the second-busiest month of the year for issuance, with €9bn of leveraged loans printing. The momentum continued into June and deals were easily absorbed by investors, with the strength of the market allowing for the majority of issuance to come from opportunistic transactions; leveraged buy outs, acquisitions and refinancings accounted for the majority of supply.

We have seen a trend of bifurcation emerge over the quarter, with investors showing more credit discipline. Deals that are perceived to be ‘better’ credits are clearing the market with ease, and in most cases tightening. On the other hand, issuers facing more challenging idiosyncratic stories have struggled through the syndication process, often amending pricing and documents along the way to sweeten the deal.

Looking ahead, the pipeline of primary loan deals remains strong and we expect the deal flow to continue right up to the summer break. Nevertheless, year-to-date volumes have fallen short of previous years, at €38.5bn so far, compared with around €60bn for the same periods in 2017 and 2018. Meanwhile, the European default rate has remained flat at 0%.

Taking a broader view, we believe the macro and political backdrop remains challenging; geopolitical headwinds like Brexit and trade tensions continue to have the potential to cause volatility. With this in mind, we maintain a cautious view, as we have for some time. Being mindful of the broader outlook for different sectors is essential, and we avoid sectors for which forward-looking indicators of health can be difficult to determine, like fashion retail.

That being said, with increasingly accommodative central bank policy expected in the coming months, the hunt for yield has begun to resurface among investors and, in our view, the asset class remains attractive. In the coming quarter, we will continue to invest in both primary and secondary, and will maintain a focus on selecting names where we see decent credit fundamentals in solidly performing, defensive businesses.

Figure 7: Opportunistic transactions account for majority of new issue supply in first half of 2019

HUNT FOR YIELD RESURFACES
AMID CHALLENGING MACRO OUTLOOK

Ulrich Gerhard
Senior Portfolio Manager, High Yield

- May pullback ends four-month streak of total return gains for high yield credit
- Refinancing risk remains low, with issuers beginning to address 2021 maturities and beyond
- Supportive central bank policy must be balanced with cautious fundamental backdrop

The second quarter continued a broader risk-on trend seen in the first half of the year, although a pullback in May acted as something of an interlude, ending a four-month streak of total return gains for high yield credit. The dip, driven by deepening macroeconomic concerns, resulted in elevated volatility and sharply wider credit spreads. An imbalance between supply and demand also detracted as heavy deal activity converged with a bout of fund outflows. CCC-rated credits bore the brunt of the ensuing credit volatility.

Nevertheless, the high yield market was back on track by June, with dovish comments from the Fed and ECB, coupled with increased refinancing activity, driving spreads tighter.

Supply was mixed over the quarter. In the US market, year-to-date issuance as at the end of June was up 25% year-on-year, totalling $132bn. However, year-to-date supply in Europe fell by almost the same proportion year-on-year (24%), to €29.9bn. The majority of high yield bond issuance is being used for refinancing purposes, while loan market deal flow is focused more on mergers and acquisitions, or on financing dividend payments.

Given how proactive companies have been in extending their capital structures, we believe refinancing risks are low, with only 5% of the European high yield market needing to refinance upcoming 2019 and 2020 maturities and less than 5% in the US. Indeed, some corporates have begun to address maturities occurring between 2021 and 2024. This leaves the market well-placed to weather short-term concerns and we expect easing central bank policy to lead to a hunt for yield among investors. This is likely to lead to an increase in investment grade accounts dipping into BB-rated companies in Europe.

As we move into the second half of the year, the macro and political outlook remains challenging, and we will need to balance our caution on the fundamental backdrop with the clearly supportive policy position coming from global central banks. Returns in this environment are likely to be driven primarily by carry and avoiding companies more exposed to areas of weakness will be crucial.

A bottom-up approach, particularly one that prioritises monitoring companies’ liquidity profiles, free cashflow generation and robust business models, will be essential. The backdrop also leads us to avoid CCC-rated credits and businesses that require growth to grow into their capital structure, as in a slowing economy, any uptick in default rates is likely to start from there. In our view, BB-rated names broadly face very little default risk given the lack of maturing debt.

Figure 8: Less than 5% of US high yield needs to refinance 2019 and 2020 maturities

Source: Bank of America Merrill Lynch High Yield Chart Pack. As at 1 July 2019.
ASSET-BACKED SECURITIES

DEMAND SUPPORTS PERFORMANCE THROUGH WIDER MARKET VOLATILITY

Shaheer Guirguis
Head of Secured Finance

- Asset-backed securities (ABS) markets generate relatively steady performance despite volatility in wider risk markets
- Technical factors continue to support European and US ABS
- Demand strong for more esoteric sectors in the US

It was a strong quarter for risk assets despite some volatility over the period. ABS markets generated positive returns, supported by technical factors as well as fundamentals, and were generally more stable than wider assets.

European ABS continued to perform well in April, with some of the strongest performance at the bottom of the capital structure as the shortage of paper became more acute. For example, spreads in the UK non-conforming loan market tightened to 2018 levels, driven by the shrinking universe as well as temporary relief in Brexit news. Performance stalled in European ABS later in May as deteriorating macro sentiment began to finally overpower the strong technical effect that a shrinking asset universe creates, but as wider investor sentiment recovered in June, the asset class rallied and generated positive returns. Issuance picked up as the quarter progressed.

We believe the senior part of the capital structure continues to offer solid yields for a modest risk profile. The picture is mixed for European CLOs, where supply continues to be heavy, and floating-rate instruments have become less attractive in the face of expected rate cuts.

The US market continued to record sustained issuance and positive returns earlier in the quarter. Unsecured consumer assets outperformed: senior unsecured consumer ABS tend to be short duration in nature, senior tranches are typically A or AA-rated, and they offer a material spread pick-up relative to other short-dated consumer sectors. Also, given the shape of the yield curve, front-end assets have become comparatively more attractive, with higher yields than assets in the 2-year to 10-year space. The US CLO market rallied, catching up with high yield and leveraged loans. In June, US structured credit lagged behind other markets as, like its European cousin, it had experienced less downside volatility in prior months. Consumer ABS spreads widened somewhat.

US consumer ABS capital structures are very flat given demand for shorter-dated carry as protection against potential volatility in other segments of the credit market. More esoteric markets like commercial real estate CLOs or single-family rentals remain very well supported, and we expect solid supply in the former over the course of the next couple of months. We remain cautious at the most junior end of the CLO market given the beta of the sector to overall structured credit.

Figure 9: Net issuance of European ABS is in negative territory year-to-date

Richard Nibloe
Portfolio Manager, Fixed Income

- The USD came under pressure due to weaker-than-expected economic data and trade tensions
- The EUR strengthened versus the USD
- Low-yielding, interest rate-sensitive currencies like the Japanese yen (JPY) should benefit from growth and trade concerns

Currencies were largely range-bound over the second quarter, oscillating without providing much in the way of breakouts from ranges. The USD trade-weighted index ended the quarter 1.19% weaker, owing partly to weaker-than-expected economic data, including manufacturing PMIs and employment figures. The ongoing US-China trade dispute, which showed little sign of de-escalation over the quarter, also weighed on the currency.

Elsewhere, there were growing expectations of policy easing by the Fed, with the policymaker largely validating market expectations in its June policy meeting, where it left interest rates unchanged, but its ‘dot plot’ projections of interest rates showed rates moving lower, with several policy makers expecting rates to be 0.5% lower by the end of the year. In other central bank meetings, the ECB upheld a dovish tilt, keeping rates unchanged and extending its forward guidance at its most recent meeting to say that rates would remain unchanged until mid-2020. Against this backdrop, the EUR appreciated by 1.38% over the quarter versus the USD. The British pound (GBP), on the other hand, weakened over the quarter, ending the period down -3.08% versus the USD, as political uncertainty continued to weigh on the currency. UK Prime Minister Theresa May was replaced by Boris Johnson in late July.

With the growth outlook continuing to soften, more growth-sensitive currencies such as the Australian dollar (AUD) and New Zealand dollar (NZD) came under pressure. We also remain cautious on emerging market currencies for now, until we have greater clarity on whether the decline in global bond yields, and possible central bank easing to come, are sufficient to stabilise the economic outlook.

The unpredictability of US trade policy makes for a difficult trading environment. News of a resolution to the US-China dispute could provide relief in some areas, but would likely prove temporary, with the administration simply moving on to other targets. Although the easing cycle may prove shallower than current market expectations, it is unlikely that global central banks will return to a hiking cycle for a considerable period of time. In our view, this environment favours low-yielding, interest rate-sensitive currencies like the JPY. In contrast, we would expect export-driven currencies such as the EUR to remain under pressure, impacted by a combination of weak global and domestic economic outlooks and a possible resumption of quantitative easing. The GBP is also likely to remain out of favour until there is greater clarity on the nature of the UK’s planned withdrawal from the EU, currently expected on 31 October.

Figure 10: USD slides due to weaker-than-expected economic data and trade tensions

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

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Fixed income

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The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

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