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Insight
INVESTMENT

QUARTERLY FIXED INCOME AND CURRENCY REVIEW AND OUTLOOK

JANUARY 2019

Part of BNY MELLON

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> If fears about the economic backdrop fade, the Fed may well continue with its gradual tightening cycle.
>
> ISOBEL LEE

OUTLOOKS DIVERGE FOR MARKETS AND ECONOMY

Isobel Lee
Head of Global Fixed Income Bonds

- Markets have diverged from the economic outlook, apparently pricing in a more pessimistic outlook than economic forecasters' projections
- Given market volatility, we believe a cautious approach is appropriate
- Trade policy is the wildcard for 2019 and will likely be a periodic source of volatility

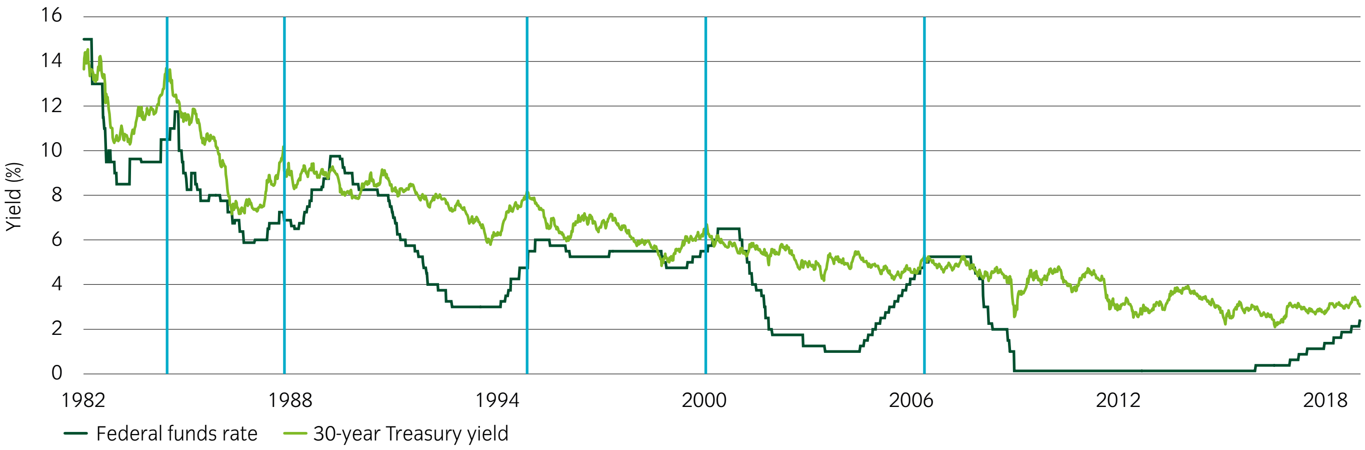
Declining equity markets, concerns about the outlook for global growth and weak commodity prices all helped to push Treasury yields lower in the fourth quarter of 2018. The yield curve flattened as shorter-maturity bond yields fell as markets reduced expectations for further interest rate hikes in 2019, but longer-maturity yields fell further (2-year Treasury yields fell by 33bp, while 10-year yields fell 38bp).

In addition to the downward shift in longer-dated yields, the market pricing for future Federal Reserve (Fed) policy also changed dramatically. At its December meeting, the Federal Open Market Committee downgraded its dot plot forecasts to expect two interest rate hikes in 2019, rather than three – but derivatives markets moved much further and started to price in the end of the tightening cycle. Whether this proves correct will likely be an important factor as to whether longer-maturity yields retain their recent gains.

At the start of 2018, if investors knew economic growth would be strong and US growth forecasts upgraded, that corporate earnings would soar and that the Federal Reserve would tighten policy four times, it's unlikely they would have expected longer-maturity Treasury yields to end the year so close to where they started. Judging when to buy longer-maturity bonds is a difficult call, especially when the Fed is still tightening monetary policy. But when we look at previous cycles, 30-year yields have had a tendency to peak before the federal funds rate (see Figure 1). We believed Treasuries were closer to fair value when they moved above 3%. At this stage, it appears a neutral duration position is appropriate until market volatility subsides.

Looking ahead, a key issue for 2019 is likely to be trade talks between China and the US. We believe de-escalation would almost certainly see a rebound in sentiment and this could potentially lead to an upward move in Treasury yields. But the relationship between the US and China is a complex one, with both countries having long-term strategic goals which may be difficult to reconcile. As such, this issue may lead to periodic episodes of volatility. Economic data and corporate earnings, especially related to orders, should start to provide greater clarity on whether the fundamental outlook remains positive. If fears about the economic backdrop fade, the Fed may well continue with its gradual tightening cycle, putting upward pressure on the yield curve. The expected expansion of US Treasury supply and the unwinding of the Fed's balance sheet both present further headwinds to Treasury markets over the medium term.

Figure 1: Federal funds rate is approaching the 30-year US Treasury yield



Source: Bloomberg, as of December 31, 2018.

ITALY RISKS
IMMINENT RECESSION

Gareth Colesmith
Head of Global Rates and
Macro Research

- Growth headwinds make rate hikes by the ECB less likely
- Italy at risk of imminent recession
- Germany and France face political risks

Economic indicators in the eurozone continued to point towards fading growth momentum. Composite purchasing managers' indices, while continuing to indicate growth in economic activity, are trending towards the lowest levels of the current cycle.

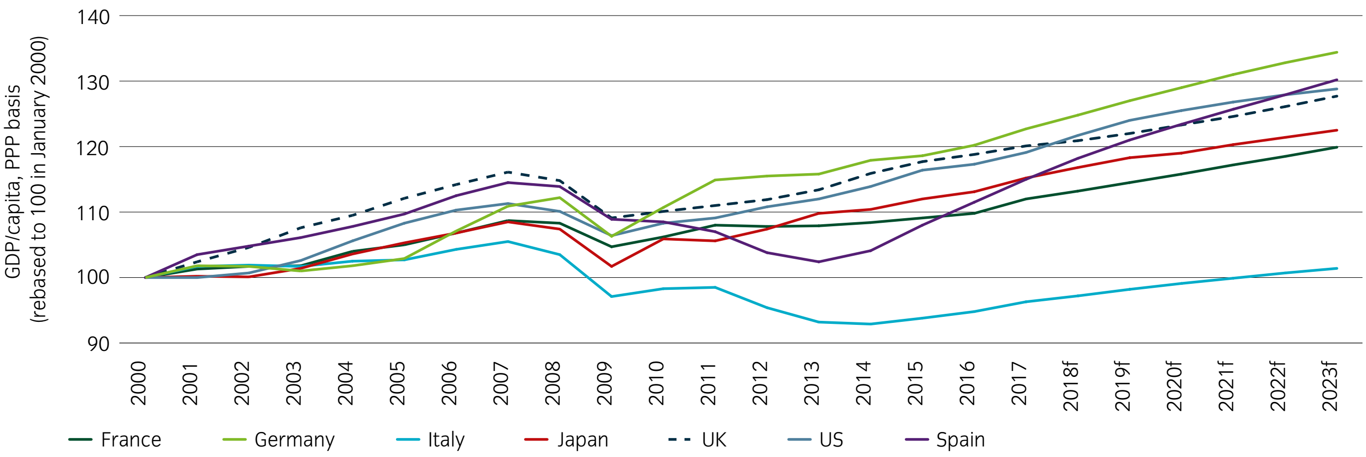
In this environment, the ECB pushed ahead with its plan to reduce monthly asset purchases from €30bn per month to €15bn and it subsequently ended the program entirely at the end of the year. With no net asset purchases at all scheduled for 2019, reports suggested it was planning a fresh program of multi-year targeted loans for banks. The ECB's stance remained that policy rates will be on hold "at least through the summer of 2019".

Political event risk remained prevalent across the continent. The conflict continued over Italy's anti-establishment government and central European powers over the Italian government's deficit proposals. The European Commission formally rejected the proposed Italian budget, but an agreement was later reached that prevented use of the Excessive Deficit Procedure against Italy for the time being. Against this backdrop, Italian sovereign spreads tightened by up to 40bp over the quarter.

In Germany, the Grand Coalition parties suffered heavier-than-expected losses in several regional votes, which splintered away from the political center. The Green Party on the left and the Alternative for Germany party on the right both made large gains, and Chancellor Merkel subsequently announced that she will not seek re-election as party leader. She remains chancellor, with 'continuity candidate' General Secretary Annegret Kramp-Karrenbauer winning the vote to replace her as party leader. In France, President Macron faced protests, initially sparked by opposition to fuel tax increases. German bund yields fell by approximately 20bp across the curve. Meanwhile, French sovereign spreads increased to their widest levels since last May 2017.

Looking ahead, given continuing economic headwinds in Europe, policy rate hikes in 2019 look increasingly unlikely. Strategically, long or short duration biases to core Europe offer little obvious value. However, this may be less true of Italy, where a recession seems increasingly likely given the tendency of Italian GDP to lag the rest of the eurozone. The recent tightening in Italian spreads looks somewhat optimistic as we believe the country's frosty relations with the European Commission are more than likely to resurface in due course. As a result, there may be attractive opportunities to implement underweight exposure to Italy.

Figure 2: Italy's economic performance has lagged far behind other major economies



Source: IMF, as of end November 2018. Data rebased to 2000.

BREXIT UNCERTAINTY INCREASES AS DEADLINE APPROACHES

Harvey Bradley
Portfolio Manager,
Fixed Income

- Gilts rally on Brexit and macroeconomic uncertainty
- BoE holds rates at 75bp
- BoE forecasts 0.2% GDP growth in Q4

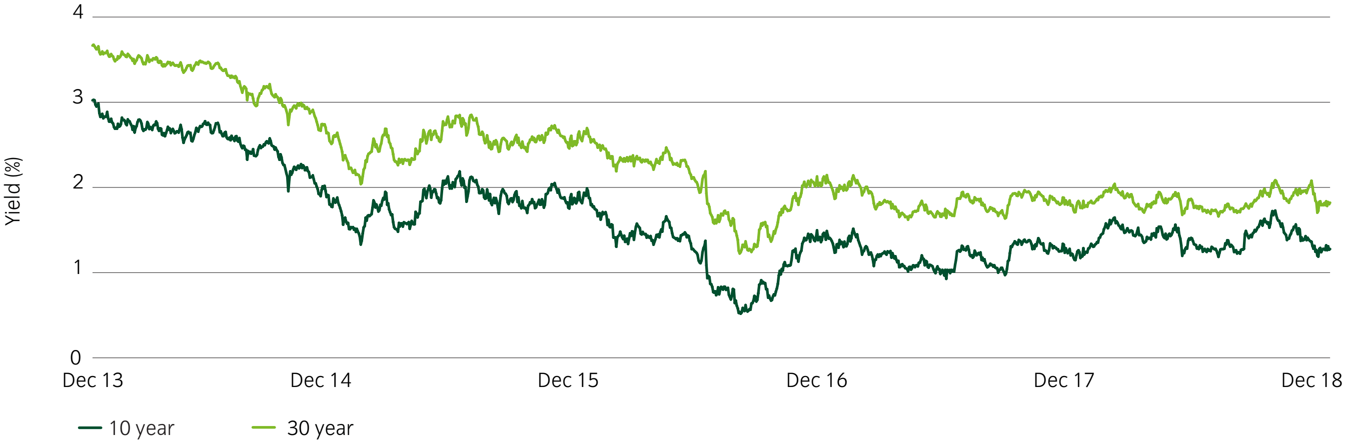
In the UK, markets faced a number of challenges over the final quarter of 2018. The ongoing uncertainty surrounding the country's withdrawal from the EU, worries over a slowdown in global growth, US-China trade tensions, political unrest in Italy and France, and a possible peak in corporate earnings caused gilts to rally during the quarter. UK government bond yields fell, reversing the rises seen in Q3: the 10-year gilt yield dropped by 30bp while the 30-year fell by 9bp.

Prime Minister May's revised withdrawal agreement gained approval from the European Commission in November, but it faced significant opposition domestically. Days after delaying a parliamentary vote on her proposed Brexit deal in December, the prime minister survived a leadership contest triggered by Conservative MPs. In January, the withdrawal agreement was voted down by a substantial majority in Parliament. The outcome of Brexit negotiations remains highly uncertain as the March 2019 deadline approaches.

After raising rates by 25bp in August, the Bank of England's Monetary Policy Committee kept interest rates unchanged during the fourth quarter. In October, the central bank cautioned that the UK economic outlook and the BoE's future monetary policy path both depend heavily on the outcome of Brexit negotiations. This sentiment was reiterated in December after the bank stated that Brexit uncertainties had "intensified considerably". The BoE softened its Q4 GDP growth outlook to 0.2%, down from the 0.3% forecast in September. It also indicated that the recent decline in oil prices is likely to cause UK CPI inflation, which reached a six-month high of 2.7% in Q3, to fall below the bank's 2.0% target in coming months. The labor market continued to strengthen with official figures showing job vacancies at record highs and wage growth accelerating through the end of the year.

Looking ahead, the timing of any changes to the Bank of England's monetary policy remains unclear due to the level of ambiguity around Brexit negotiations and the specter of slowing global growth. Given the level of uncertainty, a tactical approach to positioning remains warranted.

Figure 3: UK gilt yields rallied over the quarter



Source: Bloomberg, as of December 31, 2018.

FOCUS SHIFTS TO IDIOSYNCRATIC STORIES

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

- Indiscriminate weakness for global credit
- Idiosyncratic credit risks had a substantial impact
- Neutral credit positioning looks attractive

Risk markets endured one the most challenging quarters since the financial crisis and, despite having avoided some of the fallout earlier in the year, investment grade credit was certainly not spared in Q4. Global credit spreads retreated to their widest levels since mid-2016 and closest to their mean levels since 2009.

Negative idiosyncratic credit stories became a focus of the market. In investment grade, adverse news was particularly impactful, as it involved issuers with large capital structures and hefty volumes of outstanding debt. The most notable of these were General Electric and Anheuser-Busch Inbev, both of which were downgraded to a BBB-rating, creating material technical market impacts, which created bouts of volatility.

In Europe, macro developments also gained attention. Political developments in Italy were felt in the Italian sub-financial sector. Meanwhile, Spanish bank debt saw some volatility after the Supreme Court unexpectedly held the sector liable for certain mortgage fees.

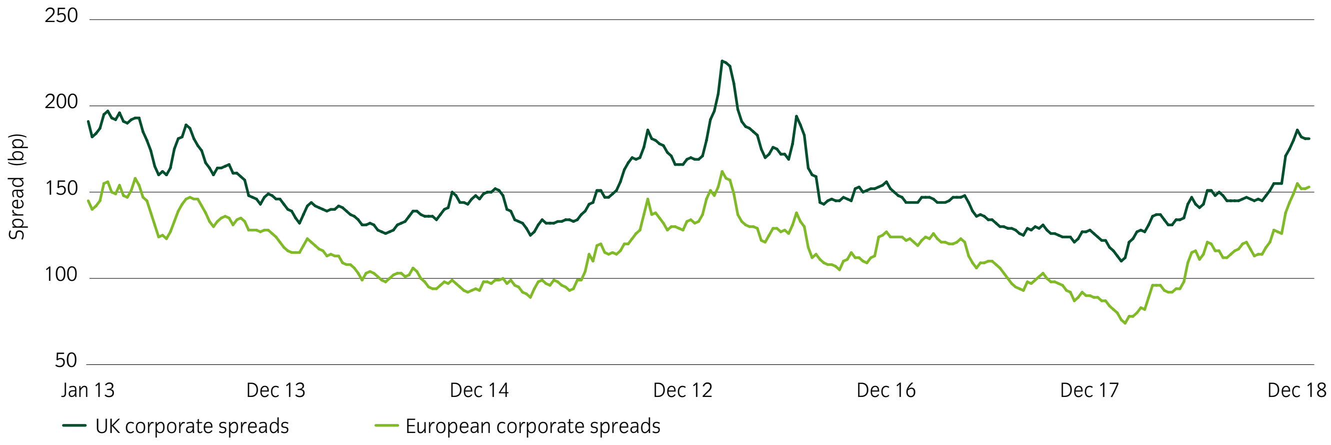
The US dollar credit materially underperformed its euro and sterling counterparts, largely reversing the outperformance that US dollar credit had enjoyed earlier in the year.

M&A activity continued to drive the largest primary market deals. Comcast issued the fourth-largest corporate deal of all time at $27bn and SAP issued five-part €4.5bn issue, one of the largest euro M&A-related deals of the year.

Looking ahead, as global liquidity conditions switch from quantitative easing to quantitative tightening, we believe a cautious approach is required. But while it might be time for investors to fasten their seatbelts, it probably is not the time to prepare for an emergency landing. From a fundamental credit perspective, markets generally look in good shape and valuations now look closer to fair value.

The most valuable strategy could be one that is close to neutral in terms of credit risk. Issuance is likely to ramp up significantly and investors may find compelling opportunities if they have some dry powder. Given the threat of continued idiosyncratic risks, we believe stock selection and credit analysis will continue to be crucial.

Figure 4: Global investment grade spreads suffered a difficult quarter



Source: Bloomberg, as of December 27, 2018.

…while it might be time for investors to fasten their seatbelts, it probably is not the time to prepare for an emergency landing.

PETER BENTLEY

TOUGH BREAK FOR US SPREADS

Jesse Fogarty
Senior Portfolio Manager

- Worst quarter for US credit spreads since 2011
- Downgrades in large capital structures contribute to volatility
- Earnings expectations are somewhat subdued – meaning potential for upside surprises

US credit markets ended 2018 on a weak note, erasing the rebound in the third quarter and delivering the market's worst quarterly spread performance since Q3 2011.

Barely any risk markets were spared during the quarter, making 2018 the worst year ever for broad asset returns based on data back to 1901.[1] For credit, this was somewhat in contrast to the rest of the year, over which investment grade credit had only mildly reflected wider equity-market volatility.

There were a number of factors contributing to the change in the final quarter. Year-end liquidity conditions exacerbated the effect of negative sentiment and outflows, but market's main focus was on central bank policy as the Fed pushed ahead with its fourth rate hike of the year and continued to reduce its balance sheet. Markets grappled with global central bank liquidity moving into contractionary territory as the economic outlook showed signs of slowdown. The Treasury yield curve slightly inverted towards the front of the curve as markets priced in a central bank policy error.

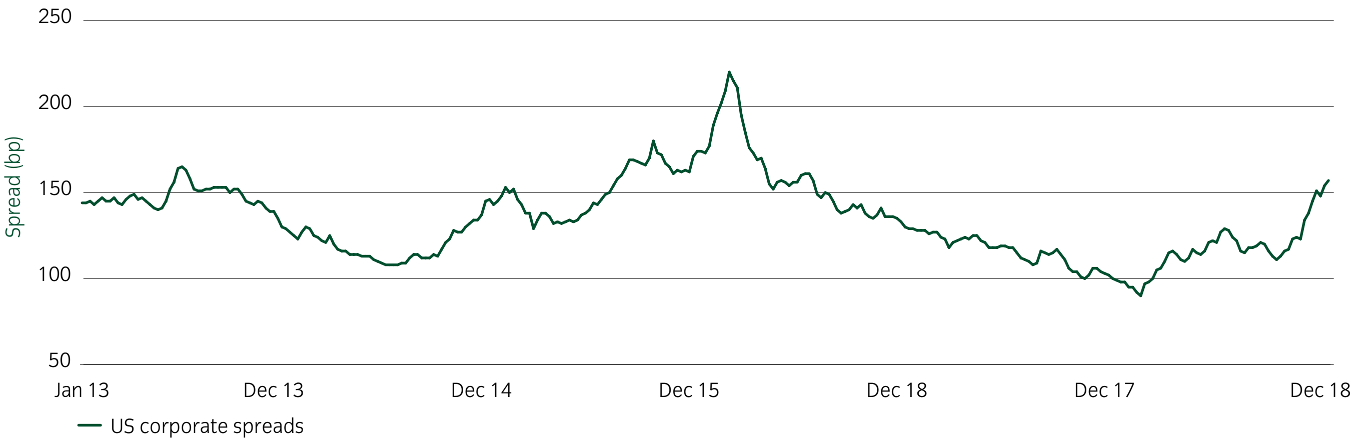
Further, persistent uncertainty around trade tensions with China and the government shutdown, as well as falling commodity prices, were further negative catalysts.

Bottom-up credit stories also generated headlines. The downgrades of General Electric, PG&E and Anheuser-Busch Inbev created material technical impacts. M&A activity also continued, with Comcast issuing the fourth-largest corporate deal of all time at $27bn to finance its purchase of broadcaster in the UK.

Looking ahead, US dollar credit has had a strong start to 2019 as markets are taking some comfort from the Fed being potentially willing to pause its hiking cycle if need be, and some constructive dialogue between the US and China over trade tensions.

Demand conditions also look relatively healthy, although the big tests will come as supply ramps up. Expectations for the next earnings season are somewhat subdued, leaving some potential room for upside surprises. Credit fundamentals generally look solid. So while we believe caution is warranted from a strategic perspective, tactically there are positives. Overall, investors may wish to keep active credit exposure light while seeking opportunities in stocks and sectors with compelling valuations. Credit selection will be key.

Figure 5: Investment grade spreads widened at year-end



Source: Bloomberg, as of December 27, 2018. [1] Source: Deutsche Bank, as of January 2018.

AN IMPROVED INCOME PROPOSITION

Colm McDonagh
Head of Emerging Market Fixed Income

- The repricing of emerging market debt has resulted in an improved income proposition
- The factors that drove volatility in 2018 are likely to persist unless corrective policy action is taken
- The outlook for US rates and the dollar will be crucial for emerging market debt performance

Volatility returned to markets in 2018. While emerging markets got an initial taste of it early in the year, developed markets caught up in December. In terms of return performance, emerging market debt held up reasonably well over the full year compared with other risk assets. Emerging market corporates only recorded modest losses of -1.2%[2], with sovereign and local currency debt markets returning -4.2%[3] and -6.2%[4] respectively. The negative return from local currency debt over the year was purely the result of currency exposure. By comparison, the S&P 500 Index returned -4.4% and the MSCI Emerging Markets Index returned -14.6%.[5]

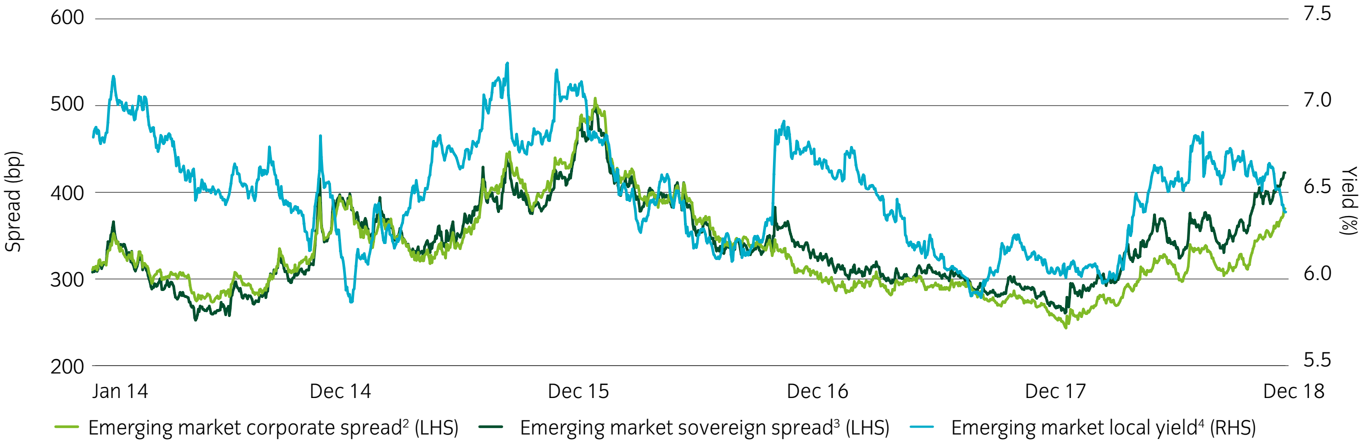
The repricing of emerging market debt has resulted in an improved income proposition. Emerging market sovereign spreads, corporate spreads and local yields widened by 130bp, 100bp and 32bp over 2018 respectively. Earlier in the year that meant considerable underperformance relative to developed market credit, although less so by the end of year.

Historically, income has formed a much larger component of total return than price movements. We therefore expect higher income to provide a greater cushion against any further price volatility. Emerging market real yields and currencies also offer value in our view. Real yields in aggregate appear to be cheap relative to developed market equivalents, currently offering close to 300bp of yield pick-up, a level last recorded in 2010. Emerging market currencies also appear to be particularly cheap according to long-term fair value models.

Global financial market conditions are currently under question. The factors that drove the volatility in 2018 – trade tensions between the US and China, the shift from quantitative easing to tightening and concerns over slowing global growth – are likely to persist through 2019 unless corrective policy action is taken. Moderating global growth is certainly to be watched, and growth in emerging markets is likely to be lower in 2019, driven by a slowdown in China and intensifying external factors. Easier fiscal and monetary policy in China is likely to mitigate this to some degree.

We also expect slowing growth to also be felt across emerging markets via second-round effects and particularly through movements in commodity markets, US Treasuries and the US dollar. These variables will likely prove to be key drivers of emerging market debt performance over the coming quarters. With 12-month US LIBOR now yielding close to 3%, the hurdle for investing anywhere in the world is considerably higher now than it was a year ago. Therefore the outlook for US rates, and the relative opportunity cost of investing in emerging market relative to US fixed income, will be crucial in determining how emerging market debt performs.

Figure 6: Emerging market debt yields rose over the year



Source: JPMorgan, Bloomberg, as of January 4, 2019. [2] JPMorgan CEMBI Broad Diversified Index. [3] JPMorgan GBI-EM Global Diversified Index, USD unhedged. [4] JPMorgan EMBI Global Diversified Index. [5] Index returns in local currency, USD terms.

We feel the loan market is better able to avoid the large swings seen in the more heavily traded equity and high yield markets.

RANBIR SINGH LAKHPURI

LOAN MARKET NOT IMMUNE TO WIDESPREAD VOLATILITY

Ranbir Singh Lakhpuri
Senior Portfolio Manager,
Secured Finance

- Loan prices in the secondary market began sliding in sympathy with the wider markets
- Primary issuance for the year fell to €95.7bn, compared with €120.7bn in 2017
- Quiet start likely for 2019

Market concerns over themes such as Brexit negotiations, trade-war rhetoric and falling commodity prices began to pervade the secured loan market during the final quarter of the year, gathering pace into year-end. Loan prices in the secondary market began sliding in sympathy with the wider markets for the first time in the year. This resulted in corrections across the board even in the European loan market, which is normally less sensitive to such moves. Thinner liquidity into year-end further weighed on market sentiment.

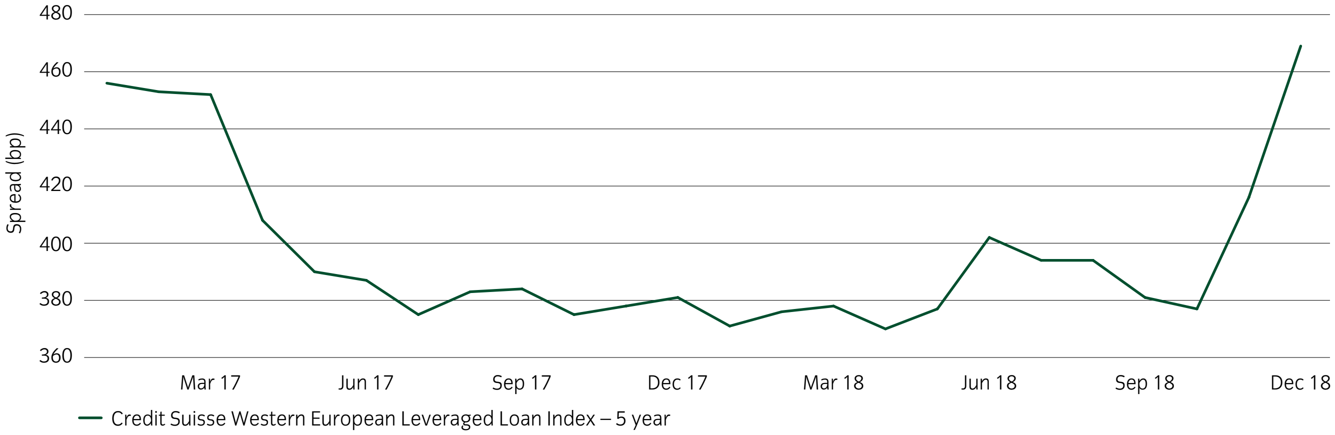
Supply slowed over the fourth quarter, meaning more opportunistic and aggressive deals began to struggle to complete. In some instances, arrangers were forced to concede on pricing and documentation in order to clear these deals. This was compounded by a diminishing flow of new buyout deals that had dominated the market for much of the year.

The slowing pace left December as the quietest month of 2018 for supply (excluding the traditionally slow month of August). Primary issuance for the year fell to €95.7bn, down from €120.7bn in 2017. That said, 70% of the year's supply was M&A-related, while the previous year's was dominated by refinancings and repricings, together equating to around 60% of 2017 issuance.

Despite the challenges presented by the fourth quarter, the loan market delivered a positive return for the year, which we feel demonstrates the loan market is better able to avoid the large swings seen in the more heavily traded equity and high yield markets.

In terms of outlook, so far in January the tone of the market has been one of cautious optimism, and we expect the start of the year to be quiet. The primary market has re-opened with a couple of well-known borrowers approaching lenders with add-ons and refinancings. However, a number of arrangers are sitting on the side-lines, waiting to see where the initial deals of the year print in order to discern the acceptable clearing level. Meanwhile, the secondary market has enjoyed a rally, retracing some of the losses seen in December. That said, prices are still hovering at or below par. As a result, we expect new-issue spreads to widen, in order to make the primary market look attractive compared to secondary.

Figure 7: European leveraged loan spreads widened materially over the quarter



Source: Credit Suisse, as of December 31, 2018.

RISK ASSET SELL-OFF IMPACTS HIGH YIELD

Uli Gerhard
Senior Portfolio Manager, High Yield

- The fourth quarter proved testing for the high yield market
- Defaults remained relatively low in the US with no defaults occurring in Europe
- An increase in fallen angels could significantly disrupt the high yield market

The fourth quarter proved testing for the high yield market, to say the least. The violent equity market sell-off spread to high yield, as investors grew increasingly concerned about exchange-traded fund outflows, slowing global growth, trade wars and the Federal Reserve's strategy. In December in particular, the high yield market deteriorated significantly, with US high yield recording a negative return that wiped out the gains made over the rest of 2018.

Geopolitical risks continued to weigh on the market in the fourth quarter. Tensions rose between the US and China over trade tariffs, with fears of a continuing escalation of the trade war dampening sentiment. Indeed, it felt like the perfect storm, with the uncertainty weighing on global growth expectations dramatically reducing risk appetite across the market.

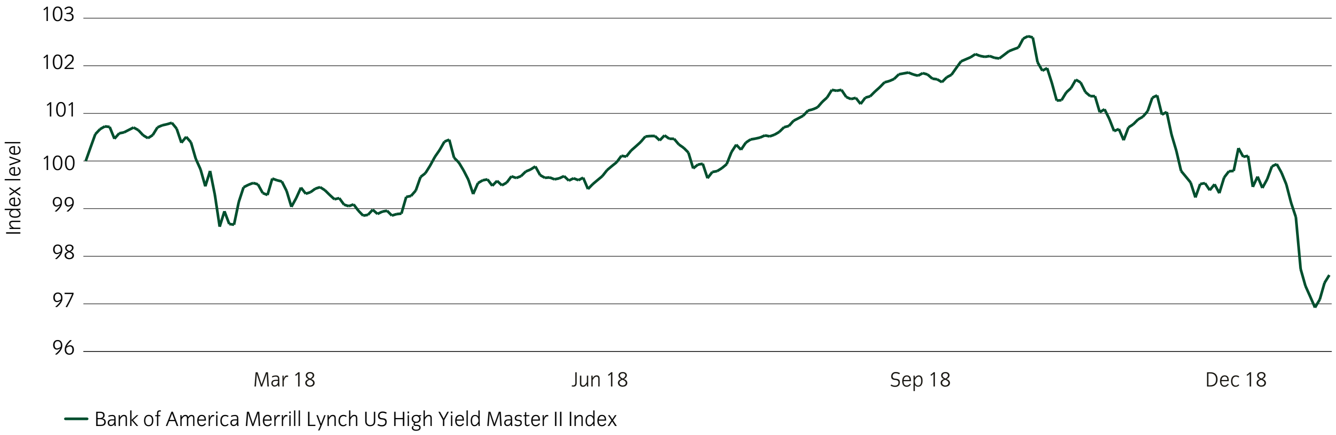
Equally, equity-market volatility impacted the oil market, with daily moves of 7% in oil contracts not uncommon. This had a material impact on the US high yield market, where a number of issuers are exposed to these markets.

As the year drew to a close, Brexit-related uncertainty dominated headlines, with negotiations seeming to make little headway, which weighed heavily on UK market liquidity. The British high street continued to struggle, putting pressure on some high yield retail names. Irrespective of the Brexit outcome, we expect the UK economy to slow down in the second quarter of 2019 and so these sectors will likely continue to suffer.

Another potential headwind could be a significant macro slowdown that leads to an increase in fallen angels. Since 2008, investment grade companies in the US and Europe have increased leverage on their balance sheets to unprecedented levels, on a par with BB-rated credits. A raft of downgrades from BBB would be difficult for the high yield market to digest, and would cause significant disruption.

More positively, defaults remained relatively low in the US over the fourth quarter, with no defaults occurring in Europe. We do believe European default risk will tick up from 2018 levels, as there are several distressed capital structures in the retail, construction and Italian corporate sectors. That said, companies have been proactive in managing their maturity schedules and have taken better care of their liquidity profiles in recent years, which should help keep defaults in check. In both the US and Europe, only around 5% of the entire market needs to be refinanced. In light of this, and given recent volatility, we expect limited new issuance in the coming months.

Figure 8: US high yield notably underperformed over the quarter, wiping out earlier gains



Source: Bank of America Merrill Lynch, as of December 31, 2018.

MARKET WEAKENS DESPITE STRONG FUNDAMENTALS

Shaheer Guirguis
Head of Secured Finance

- Structured credit spreads widen in line with broader risk markets
- CLOs underperform other sectors
- Given the re-pricing, increasingly attractive opportunities in ABS markets in our view

Structured credit markets suffered over a difficult quarter for wider risk assets, though the underlying fundamentals remained strong, in our view – presenting potentially attractive opportunities for investors.

Sentiment worsened as the quarter progressed. Slowing growth, ongoing trade concerns and falling commodity prices all had an impact, though it appears the ongoing regime change in central bank policy was also weighing on overall performance.

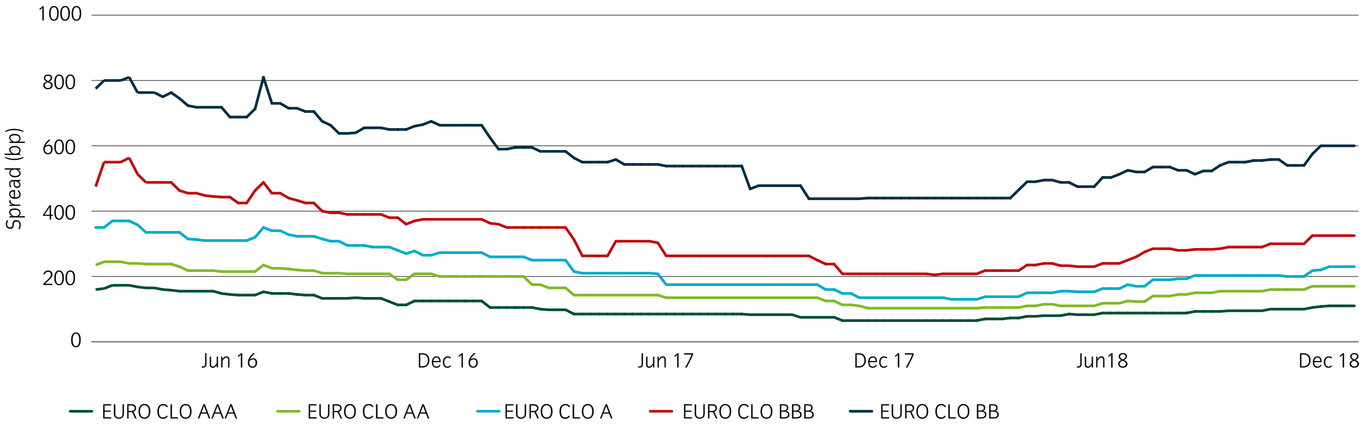
In October, risk assets suffered a sharp drop, but structured credit markets largely weathered the fall as carry largely offset falls in capital values. However, as broader weakness continued, structured credit markets recorded negative returns in November and December as liquidity dropped and higher-beta sectors underperformed, such as CLOs. In December, structured credit markets continued to decline in sympathy with wider credit, and CLOs continued to underperform.

Issuance continued apace over the quarter, with deals printing at wider spreads as time progressed, in line with widening spreads in the secondary market. That said, issuance in Europe was largely absent in December as is typical for year-end, and increased volatility also discouraged issuers from printing deals in hope of better market conditions.

The difficult fourth quarter meant that over the year as whole, senior residential and consumer spreads widened by around 50bp. Further down the capital structure, spreads widened by 75bp to 100bp.

We believe that this re-pricing presents potentially attractive opportunities for investors in the ABS markets, which in our view remain structurally attractive and well-placed to withstand current market concerns such as global trade tensions, Brexit or rising central bank policy rates. Continuing improvements in the real global economy have left consumers in better shape. For some investors, it could be a good time to lock in a rare source of credit spreads, floating-rate cashflows and defensive structural protections.

Figure 9: CLO spreads widened in Q4 and over the year as a whole



Source: JP Morgan, as of December 28, 2018.

GLOBAL SLOWDOWN CONCERNS WEIGH ON SENTIMENT

Paul Lambert
Head of Currency

- Fears of slowing global growth gradually rose, culminating in a difficult December for equities and credit
- The Japanese yen (JPY) saw safe-haven flows late in the quarter, amid a backdrop of falling Treasury yields and weakness in risk assets
- Global growth concerns are forcing markets to question the Fed's rate hiking path, resulting in pressure on the USD

Fears of slowing global growth rose throughout the fourth quarter, culminating in a difficult December for equities and credit. Against this backdrop the US dollar (USD) began strongly, supported by hawkish comments from Fed Chairman Jerome Powell, who suggested that rates may have to rise above neutral. The Fed opted to raise rates by 0.25bp in December.

The US midterm elections took place during the quarter, with the results coming in as expected. The Democrats won control of the House of Representatives and the Republicans retained the Senate. The USD weakened, reflecting diminished chances of further fiscal stimulus, given the gridlocked congress.

Overall, price action in the USD was choppy, with sizeable moves in both directions. However, as the quarter drew to a close, US equity-market weakness and declining US Treasury yields prompted a dip in the currency's performance. Despite these headwinds, the US Dollar Index rose 1.09% in Q4.

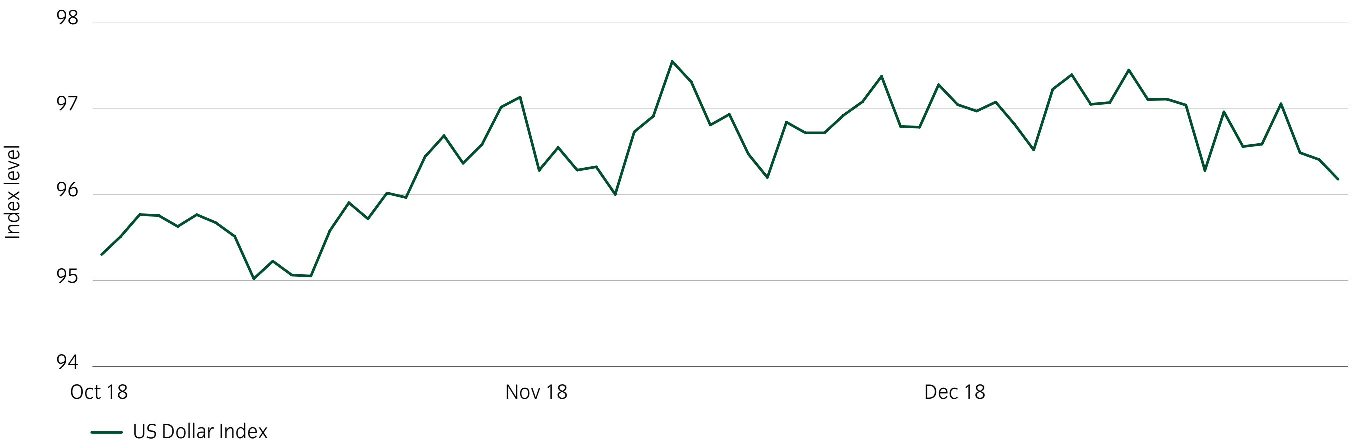
Against this backdrop, emerging market currency performance was mixed. The South African rand depreciated 1.5% during the quarter, while the Brazilian real appreciated by 4.3%. A falling oil price caused oil-producer currencies like the Canadian dollar, Norwegian krone and Russian ruble to weaken, and they fell 5.3%, 5.6% and 6.0%, respectively.

The instability meant the JPY benefited from safe-haven flows late in the quarter, amid a backdrop of falling Treasury yields and weakness in risk assets. The JPY strengthened by 3.7% over the quarter.

In Europe, Brexit continued to dominate headlines as a draft withdrawal agreement was faced with substantial opposition and led to a vote of no confidence in Prime Minister May. Sterling dropped by 2.13% over the quarter.

Looking ahead, global growth concerns and weakness in risk assets are forcing markets to question the Fed's rate hiking path, resulting in pressure on the USD. A moderation in growth and fading fiscal stimulus in the US means that we expect USD weakness to be most pronounced versus large current account surplus currencies like the JPY, euro and Swiss franc. We also expect growth-sensitive currencies, like commodity exporters, to remain under pressure.

Figure 10: US dollar recorded a choppy quarter



Source: Bloomberg, as of December 31, 2018.

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