FINANCIAL IMBALANCES EASIER TO Spot IN hindsight

Long cycles generally bring with them the risk of financial excesses. It is not a coincidence that the last two recessions were preceded by asset class bubbles which then burst. Indeed, since the early 1990s, recessions have coincided with bear markets. Financial excesses in the late 1990s and in 2007-2008 led to extended asset-price adjustments (inflated stock prices for the former, and the elevated real-estate values that lay at the heart of the sub-prime crisis for the latter) which had severe economic consequences. Currently, we see limited evidence of such concerns but debt levels are high, and financial imbalances are easier to spot with the benefit of hindsight.

Matthew Merritt, Head of Multi-Asset Strategy Team

ITALY REMAINS AN ACCIDENT WAITING TO HAPPEN

Italian politics has grown noisier once again, with a number of factors driving the increased political tensions, including allegations about illegal Russian financing of Lega via Rosneft and Eni. We have said for some time that we believe Italy is an accident waiting to happen; Italy’s debts are higher now than Greece’s were before its crisis erupted. However, Italian spreads over bunds – which have oscillated around 150bp to 250bp in the last few months – are trading at a fraction of the wides on Greek debt at the height of its crisis. With budget talks to resume in the autumn, tensions within both the Italian government and with the EU are likely to cause idiosyncratic Italian risk to be priced back into markets, in our view. The prospect of a highly charged election campaign is also likely to weigh on sentiment.

Gareth Colesmith, Head of Global Rates and Macro Research

IT’S A BOND PICKERS’ MARKET IN US CREDIT

As the US economy shows signs of slowing potentially to 2% this year and corporate earnings come under pressure, duration is no longer a bad word. It makes sense to own high-quality US fixed income assets at present. However, importantly, the market is probably being too optimistic in its expectations of rate cuts given the current strength of the US consumer. Markets could be priced with some room for disappointment, which could be of particular concern to those owning beta exposure to highly-levered credits. This is very much a bond picker’s market: those allocating selectively into attractive income opportunities based on thorough credit analysis will likely be best-positioned in the current credit environment.

Gautam Khanna, Senior Portfolio Manager, Fixed Income
THE US CONSUMER MAY ANCHOR US GDP IF TRADE WARS DEEPEN

The consumer accounts for 70% of GDP, but corporates account for less than 20%. In any economic deterioration, especially one led by global trade wars, corporates will be first in the line of fire. They will have to make the tough choice of either passing on higher fixed or variable costs to the consumer, or ‘swallowing’ them and accepting lower profitability for themselves. This earnings season has already shown challenging performance from some industrial bellwethers, particularly relating to trade concerns. Given the trend over the last few decades of stagnant real wages yet rising corporate profit margins, it is questionable whether corporates will be able to push any future weakness onto the consumer. This time it may be their turn to see no real improvement for a few decades.

Yet the consumer, helped by disruptive technological changes that make things like taxi rides materially cheaper, seems quite robust and potentially more insulated by being second in the line of fire after corporates, or perhaps even third after corporates and governments. Unemployment is around a 50-year low, labour force participation is improving, and nominal wage growth and retail sales are showing some strength.

For investors, however, most investable assets are corporate-focused. Finding investable and compelling opportunities to diversify into the potentially economically better-positioned and far less crowded consumer risk segment is not easy. The secured finance market may be the best avenue, as it can offer isolated consumer credit risk exposure subject to credit enhancement, structural protections and security against hard assets in the event of default. Now could be the time to consider such an approach.

Alex Veroude, Chief Investment Officer, North America, Fixed Income

EASING CENTRAL BANK POLICY LIKELY TO LEAD TO A SEARCH FOR YIELD

Although global growth is moderating we believe it will remain sufficiently strong to allow those companies with solid business plans to continue with their deleveraging trajectory. 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. Companies continue to extend their capital structures, with some already starting to refinance maturities occurring between 2021 and 2024. This leaves the market well placed to weather short-term concerns and we expect that easing central bank policy will lead to a search for yield amongst investors.

Ulrich Gerhard, Senior Portfolio Manager, High Yield
Looking forward, the onus is on the growth data to show sequential signs of stabilisation and improvement. Brexit, of course, remains a wildcard, and even with the revised 31 October deadline approaching, the range of outcomes is uncomfortably large. In Europe, the tussle between a more populist approach to policy versus the current orthodoxy, demonstrated by the fact that anti-establishment parties won 28% of seats in the May European parliamentary elections, is likely to come into sharper focus – even more so given the fragile European growth backdrop. A shift in the balance of power would affect key EU policy agendas such as budgetary matters and the appointment of senior personnel and trade. The greater fragmentation of the vote leaves some uncertainty as to the coalitions that will form in the coming months and the results could have repercussions on national politics impacting the prospects for eurozone reform.

**US GOVERNMENT BONDS**

Isobel Lee, Head of Global Fixed Income Bonds

The persistent lack of inflationary pressure increases policy flexibility and markets, sensing a change of direction, have moved to anticipate a significant easing cycle.

For investors, the momentum in market action has to be weighed against the potential that the Federal Reserve (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 stabilize 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.

**GLOBAL INVESTMENT GRADE CREDIT**

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

We believe the tactical outlook for global credit looks favourable, particularly going into 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, are related 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.

**US INVESTMENT GRADE CREDIT**

Andrew Catalan, Head of US Long Duration

Credit markets are likely to be well-supported by accommodative monetary policy and low supply over the summer. With a record $13trn 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 which an emphasis on the most attractive bottom-up stock selection opportunities.

**SECURED LOANS**

Ranbir Singh Lakhpuri, Senior Portfolio Manager, Secured Finance

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. 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, loans remains attractive as an asset class.
HIGH YIELD

Ulrich Gerhard, Senior Portfolio Manager, High Yield

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.

The backdrop also leads us to believe avoiding CCC-rated credits, and businesses that require growth to grow into their capital structure, is sensible. 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.

ASSET-BACKED SECURITIES

Shaheer Guirguis, Head of Secured Finance

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 collateralised loan obligations (CLOs), where supply continues to be heavy, and floating-rate instruments have become less attractive in the face of expected rate cuts.

In our view, 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.

CURRENCIES

Richard Nibloe, Portfolio Manager, Fixed Income

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 Japanese yen. In contrast, we would expect export-driven currencies such as the euro to remain under pressure, impacted by a combination of weak global and domestic economic outlooks and a possible resumption of quantitative easing. Sterling 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.

EMERGING MARKET DEBT

Colm McDonagh, Head of Emerging Market Fixed Income

A return to policy easing may 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.

Positive catalysts to emerging market debt performance may come from weaker US dollar (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).

UK GOVERNMENT BONDS

David Hooker, Senior Portfolio Manager, Fixed Income

The Bank of England’s Monetary Policy Committee 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.

Following a six-week long leadership contest, Boris Johnson was appointed Prime Minister at the end of July, replacing Theresa May. We retain a cautious stance on the UK given the wide array of potential outcomes that are possible before the end of 2019. Ultimately, the political outcomes have the potential to be both a positive and a negative for gilt yields, and we believe greater clarity is needed before taking any significant position.
MARKET REVIEW AND CONSENSUS FORECASTS

Equity markets (total return, local currency)¹

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<tr>
<td>FTSE 100</td>
<td>19%</td>
<td>1%</td>
<td>-1%</td>
<td>19%</td>
<td>12%</td>
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<tr>
<td>FTSE All-Share</td>
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<td>1%</td>
<td>1%</td>
<td>17%</td>
<td>13%</td>
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<td>4%</td>
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<tr>
<td>S&amp;P 500</td>
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<td>14%</td>
<td>1%</td>
<td>12%</td>
<td>22%</td>
<td>-4%</td>
<td>8%</td>
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<tr>
<td>Euro Stoxx</td>
<td>22%</td>
<td>4%</td>
<td>6%</td>
<td>4%</td>
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<tr>
<td>Topix</td>
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<td>10%</td>
<td>12%</td>
<td>0%</td>
<td>22%</td>
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Currencies¹

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<td>GBP-USD</td>
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<td>-6%</td>
<td>-5%</td>
<td>-16%</td>
<td>10%</td>
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<td>GBP-EUR</td>
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<td>5%</td>
<td>-14%</td>
<td>-4%</td>
<td>-1%</td>
<td>3%</td>
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Bond markets (Bloomberg Barclays)¹

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<td>US Treasury</td>
<td>-3%</td>
<td>5%</td>
<td>1%</td>
<td>1%</td>
<td>2%</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td>US Corporate</td>
<td>-2%</td>
<td>7%</td>
<td>-1%</td>
<td>6%</td>
<td>6%</td>
<td>-3%</td>
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<td>US High Yield</td>
<td>7%</td>
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<td>-4%</td>
<td>17%</td>
<td>8%</td>
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<td>Pan European Corporate</td>
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<td>1%</td>
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<td>2%</td>
<td>-2%</td>
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<tr>
<td>Pan European High Yield</td>
<td>10%</td>
<td>7%</td>
<td>3%</td>
<td>6%</td>
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<td>-4%</td>
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Real GDP¹

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<td>2018⁰</td>
<td>2019⁰</td>
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<tr>
<td>US</td>
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<td>Eurozone</td>
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<tr>
<td>Japan</td>
<td>0.8</td>
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<tr>
<td>China</td>
<td>6.6</td>
<td>6.2</td>
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<tr>
<td>Developed markets</td>
<td>2.3</td>
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<tr>
<td>Emerging markets</td>
<td>4.94</td>
<td>4.91</td>
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<tr>
<td>Global</td>
<td>3.7</td>
<td>3.5</td>
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CPI¹

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<th>Versus previous year</th>
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<tr>
<td></td>
<td>2018⁰</td>
<td>2019⁰</td>
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<tr>
<td>US</td>
<td>2.4</td>
<td>2.0</td>
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<tr>
<td>Eurozone</td>
<td>1.7</td>
<td>1.5</td>
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<tr>
<td>Japan</td>
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<td>1.0</td>
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<tr>
<td>China</td>
<td>2.1</td>
<td>2.2</td>
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<tr>
<td>Developed markets</td>
<td>2.3</td>
<td>2.0</td>
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<tr>
<td>Emerging markets</td>
<td>3.52</td>
<td>3.64</td>
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<tr>
<td>Global</td>
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Forecasts and forecast returns are estimates based on data that is currently available. As such, they are not a reliable indicator of future performance. ¹ Source: Bloomberg, data as at 30 June 2019. ² Estimate. ³ Forecast.
THOUGHT LEADERSHIP

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Fixed income quarterly
Insight’s investment experts review recent market performance and offer their views on the outlook for a range of fixed income asset classes and currency markets.

INTERREGNUM
We are in a period of rapid transition. The forces that have shaped our world since the Second World War are in decline while the forces likely to shape our future are as yet unclear. We examine the causes and implications for investors.

Responsible Investment Quarterly
European rules on environmental finance and green bonds likely to boost future impact bond issuance. Year-to-date impact bond issuance is already over US$100bn, suggesting total issuance in 2019 will be the highest on record. Inaugural green bonds from telecommunication companies in Europe and the US suggests more green bond diversification.
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.

ASSOCIATED INVESTMENT RISKS
Fixed income and Multi-asset
Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.
A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
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.
Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.
Property assets are inherently less liquid and more difficult to sell than other assets. The valuation of physical property is a matter of the valuer’s judgement rather than fact.
Investment in any strategy involves a risk of loss. Trade finance exposure is complex and is exposed to credit and other risks. It is not actively traded and this may impair the ability of a portfolio to realise full value in the event of the need to liquidate such investments.

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