FIXED INCOME UPDATE

ANDREW LAKE, HEAD OF FIXED INCOME AT MIRABAUD ASSET MANAGEMENT, SHARES HIS VIEWS FOR THE FIXED INCOME MARKET IN 2019.

INTRODUCTION

The market is in an optimistic mode despite the carnage of December 2018. Much of that can be attributed to year end positioning, fear and liquidity. There was no rational reason for the sell-off and the rally we have seen in January is evidence of that. We are reverting to levels pre-December when the market was still not thinking about recession in 2019, but was thinking about 2-3 interest rate hikes. A lot has changed since then. December fears of an imminent US recession in 2019 were brought about by year end panic rather than any basis in fact. Since then the Fed has soothed markets and dialled back its projections for rates to rise in 2019. Add a very strong US jobs report into the mix and the bounce back in January is easy to justify.

Interestingly, volumes are still low, with Real Money investors sitting mostly on the side-lines for now. If the rally is sustained over the next few weeks, then we could see a grind higher as market participants feel that they have to get involved. The High Yield market has already tightened 100bps in a very short space of time, inflows have resumed, and the death of High Yield at least for this cycle has clearly been exaggerated. Whilst this has taken us back to pre-December collapse levels the question of what takes us tighter from here has to be examined.

Optimism of a resolution between the US and China combined with the market now pricing in no further interest rate rises in the US in 2019 has seen risk rally again. With US GDP growth projected to be around 2% in 2019, combined with low inflation and no interest rate rises we are back in the Goldilocks environment for risk assets. Could 2019 be another 2016 year of performance? Certainly, many strategists have increased their return outlook for both US corporate bonds and equities. Markets always over compensate either one way or another and so it is a good time to discuss whether the consensus trades for the year are likely or not.

In addition, we will discuss fund positioning for the year in light of what we do know, and what we do not.

TOP RISK EVENTS FOR 2019

US/China trade agreement

December gauges of consumption and factory output in China accelerated even as Q4 growth slowed to 6.4%. China has a number of stimulatory rabbits to pull out of its hat but even if the slowdown is shallower than at first feared, it will weigh on global growth. The market is so far taking recent weakening combined with more robust retail sales (ex-autos) and other data as a sign that the slump is bottoming. December was better as a result of targeted stimulus. Any resolution of the trade dispute will reinforce that view. The market is assuming a resolution before the March deadline. The Chinese want a resolution as the impasse is affecting the economy and I am sure President Trump would like a quick win. An extension of this will ultimately impact the US as well. Having said that, it would seem that there is still a lot to be done and no real agreement on the thorniest issue which is the alleged theft of intellectual property. There are thus risks to the downside.

US Government shutdown

The shutdown is not really a focus at present. The market is assuming that it is resolved over the next couple of weeks and if that is the case then the economic effect is fairly minimal. A Bloomberg survey of 30 economists assumes that the latest date for resolution is the first half of February, and that if that were the case the median effect on US GDP would be -32bps.

The real risk here is that it extends beyond expectations. The longer it goes on the more detrimental it will be. The same survey illustrates that if the shutdown were to end on the 31 March, the median impact would be -80bps. Given expected GDP in Q1 2019 is 2.2% that is a significant effect.

At present both sides are entrenched with increasing animosity between President Trump and Speaker Pelosi. It is hard to see what will break the impasse in the short term, so a re-pricing of the risk the shutdown extending could negatively impact markets especially given the current nervousness over economic growth faltering.

Fed and Interest Rates

The Fed dialled back its interest rate projections after the negative reaction to Chairman Powell's comments in December. Since then a succession of Fed governors has been in the press stating a more dovish outlook, data dependent, etc. Two rate rises are now being projected for 2019, and it is likely that there is a pause in March to take stock of the environment. The market in typical fashion is now pricing in no rate rises for 2019. 3.5% for the US 10-year Treasury seems off the table for now, and a 3% peak looks the most likely target to aim for (if at all) given stubbornly low inflation and some evidence of deteriorating data. A much lower oil price will also help both consumer discretionary spending and inflation.

Anecdotal evidence would seem to suggest that inflationary pressures are building in the supply chain and as a result of tariffs. Wages are beginning to pick up but not to the extent one would expect given the employment level. The participation rate is increasing somewhat as more Americans go back to work so that could be why wage growth remains fairly subdued.

If we do see a pickup in inflation from here, then there is no reason to expect the Fed to remain static for the full year. Indeed, the economy is still growing robustly and so the market may well be underestimating the Fed at this point in my opinion.

Corporate Earnings

Early days but so far poor results from Halliburton, Johnson & Johnson and Stanley Black & Decker weighed on the industrials and consumer discretionary sectors. All three companies followed their latest quarterly reports with management comments about a challenging outlook ahead, highlighted by Black & Decker CEO Loree saying “economic growth is slowing". The key will be the outlook for the rest of 2019. Last year the market wobbled as Caterpillar downgraded its outlook on increased tariff costs. Whilst tariffs were not increased on the 1 January this year, the uncertainty around trade plus the cost of current tariffs may weigh on companies' activities and margins. It is likely that we will see a decent Q4 2018 but if we see the general outlook downgraded then we will see some pressure on markets.

Primary Market Issuance

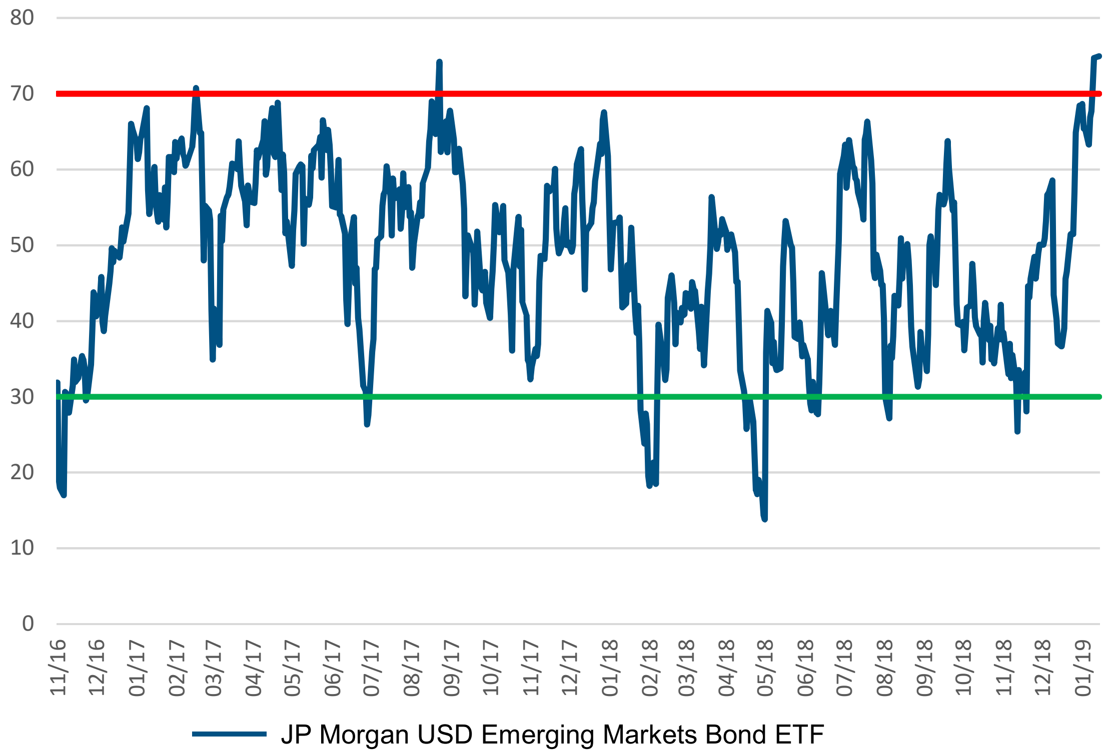
So far we have seen very strong demand for deals, upsized and over-subscribed with attractive new issues premiums and some issuers willing to offer concessions hitherto off the table. Whilst we saw very little new deal activity in the last few months of 2018, with the current rally, levels are looking interesting again for issuers so we should see a pick-up in deal flow. This will begin to impinge on cash balances as investors use new issues to take market exposure given the illiquidity of the secondary market.

US Dollar and Emerging Markets

I have linked both the dollar and EM together given the symbiotic relationship that they have. EM had a very difficult year last year as a result of a confluence of idiosyncratic issues that engulfed the asset class. Given where valuations currently are, plus the view that with less interest rate rises in the US we should begin to see some of the recent dollar strength dissipate there is an increasingly loud voice of strategists calling for a rebound in EM this year.

Let us not forget that there is a correlation to High Yield and general risk appetite, so the US dollar is just one aspect to consider if not the most important for many investors.

There are still plenty of hurdles to overcome this year and so we should not get too carried away this early on. Much is hanging on the resolution of the China/US trade issues.



Source: Bloomberg as of 22/01/2019

- Turkey – has anything really changed?
- Russia – still the threat of sanctions
- Argentina – elections
- Mexico – AMLO uncertrainty
- Middle East – geo-political/oil volatility
- South Africa – threat of land appropriation, economic mismanagement
- China – economic slowdown uncertainty

Europe – will they or won't they?

The situation in Europe looks increasingly problematic. At the end of last year, I was forecasting two very different scenarios. In scenario 1 the economic malaise reversed as a result of a more benign global trade environment, the 10-year Bund widened significantly from current levels, and European fixed income sold off, with a rate rise at the end of the year. In scenario 2, the economic decline deepened, the ECB is unable to raise rates, the corporate credit environment declines and Bunds rally. Again, the outlook for European bonds ex Bunds would be negative.

At the moment, scenario 2 is looking like the most likely outcome from where we sit in January, obviously this can change, especially if China/US trade is sorted out. The ECB looks to be behind the curve now and will find it very difficult to raise rates. Could we see more QE?

Stoxx 600 saw annual declines in most years when it peaked in the first quarter…

	Date of Peak	Annual Move
2018	Jan 23	-13%
2017	Nov 1	-7.7%
2016	Jan 4	-1.2%
2015	April 15	-6.8%
2014	Dec 5	-4.4%
2013	Dec 30	-17%
2012	Dec 19	-14%
2011	Feb 18	-11%
2010	Feb 18	-8.6%
2009	Dec 29	-28%
2008	Jan 23	46%

Source: Bloomberg

The bund yield has climbed 10 basis points from its two-year low reached earlier this month as some of the recent data -- retail sales, GDP, jobs -- don't support talk of a looming recession. Optimism on trade talks also boosted risk sentiment. But since inflation expectations seem to be closely related to the economic surprise index, as Commerzbank noted[1], a decline in price growth expectation to an 18-month low deserves attention.

While risk of a recession may seem exaggerated at this point, the euro-area economy is slowing. Inflation is easing, and that raises the question of whether disinflation is staging a comeback. That makes analysts' median forecast for 10-year yields to rise to 60 basis points by mid-2019 look rather optimistic. [2]

[1] Source: Anchalee Worrachate, Markets Reporter London

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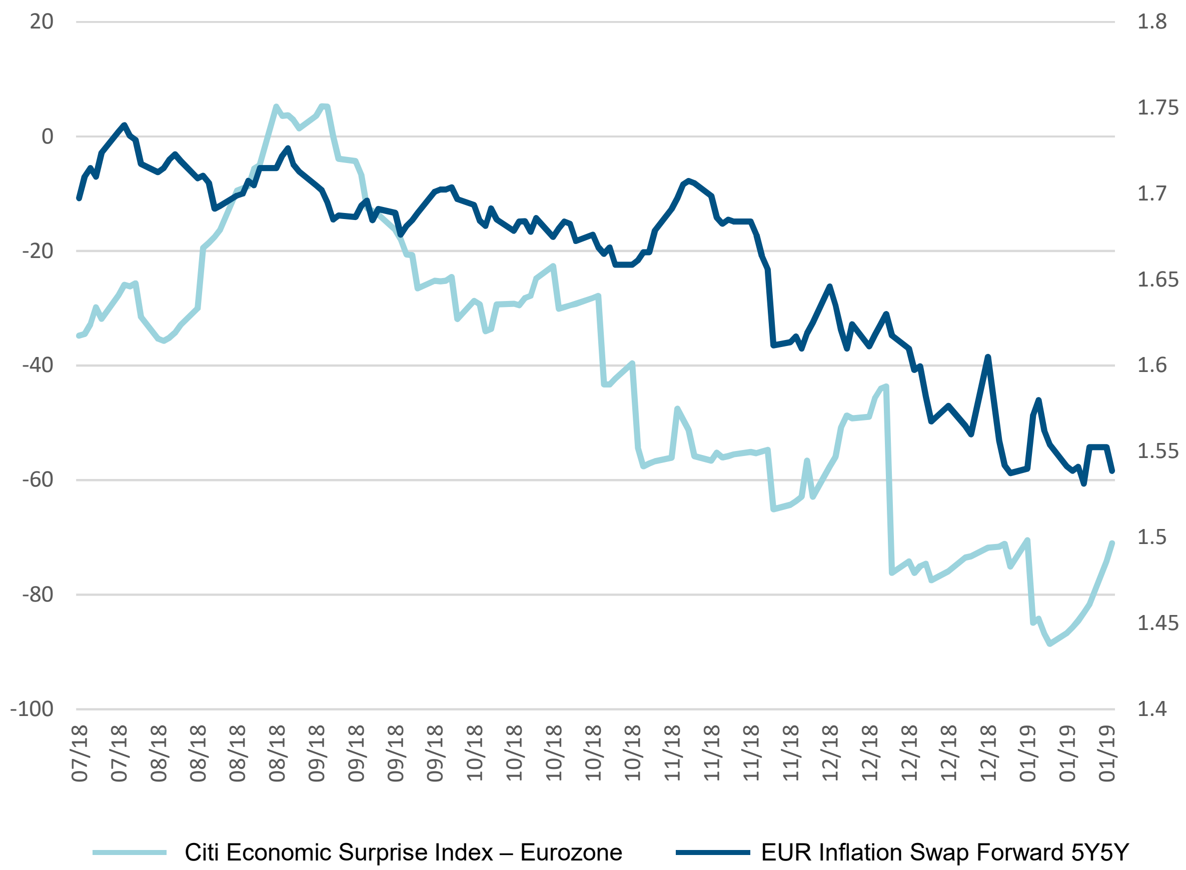

Source: Bloomberg as of22/01/2019

Brexit

It looks like we are moving to a delay of Article 50. There is still the real risk of a no deal Brexit given how the Government has mis-managed the process so far. The market and Sterling still seems to be pricing in a soft Brexit or delay.

Oil

Oil has rallied strongly this year and for market strength to continue we will need to see this continue. Much will depend upon the supply/demand relationship. The OPEC cuts have and will help the situation but if we do see a general slowdown in economic activity then this will pressure the supply side dynamics.

FUND POSITIONING – WHAT WE HAVE CHANGED

Overall 2019 has as many different scenarios as we saw in 2018

- US/China trade
- Geo-politics
- Is there a recession coming in Europe/US?
- China managing its slowdown
- Brexit
- The US dollar

To mitigate these risks, we have moved all of the portfolios into a more defensive posture.

The Mirabaud – Global Strategic Bond Fund has reduced High Yield to approximately 20%. The constitution of the High Yield bucket has also changed. We have been focusing on better quality, short maturity bonds for the most part. We will continue to focus on this asset class as it constitutes the riskiest part of the portfolio. In addition, short dated US Treasuries and cash amount to 30% of the overall Fund, which is the highest it has been for some time. We continue to be negative on European fixed income. The overall rating of the Fund is now BBB+.

The Mirabaud – Global High Yield Bonds Fund has also been reducing risk to a certain extent. The focus is very much on fundamental credit strength and we have increased both short dated High Yield and cash on the Fund. We continue to be negative on European high yield despite the recent re-pricing. The Fund rating is now BB.

The Mirabaud – US Short Term Credit Fund has focused almost entirely on very short credit exposure. We have also reduced the interest rate hedge as a result. The Fund rating is now BBB.

We feel that a defensive strategy is the best answer to the current uncertainty in the market. We continue to believe that Fixed Income will have a positive year of performance but navigating the many hurdles will be key to this. The US continues to remain our area of primary focus although we are beginning to look at more opportunities in EM as well.

CONCLUSION

There are many reasons to be optimistic for Fixed Income investors this year. The US continues to enjoy robust growth and will continue to do so this year. The Fed has indicated 2 rather than 3-4 rate hikes this year. Inflation is still low. The sell off at the end of December 2018 re-set valuations to attractive levels and there is still the desire for yield from investors. We think that a recession is clearly not coming in 2019. Europe is clearly struggling but the ECB may well support the market with further QE. Emerging Markets look interesting given current valuations and a potentially weaker US dollar this year.

At this point we know what the risks are and whilst one can argue that they are not fully priced in, we believe there will be opportunities to add alpha as a result of some of this volatility. China/US trade and the US government shutdown are the most immediate hurdles to overcome. Brexit, oil and the withdrawal of quantitative easing across the Developed World will continue to be areas of uncertainty. Given the Funds' positioning we feel that we are well placed to take advantage of some of this volatility should it un-fold.

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