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MAPPING MARKETS
REVIEW AND OUTLOOK

JUNE 2018

Part of BNY MELLON

TALKING POINTS

“Iran added around 1 million barrels per day of production following the removal of sanctions and the question now is how much of this supply will be removed from markets if sanctions are reinstated. Around 50% of Iran’s exports are to China, India and Turkey, who may be more resistant to implementing US-based sanctions while other Asian buyers that consume another 20% of Iranian exports will likely apply for a waiver to purchase oil. The market impact of US sanctions may thus be more moderate than the recent price action suggests. In our view, the main beneficiaries of higher prices are North American producers and midstream companies, most of whom own assets which are highly profitable when oil is above US$55. Even before this recent price action the EIA had increased their US on-shore production expectations for 2018 and 2019. We’re taking a more cautious view on longer-term demand growth and the sustainability of elevated oil prices as domestic consumers will be hit by higher prices at the pump and non-US consumers face additional price increases as result of the strengthening dollar.“

Jesse Fogarty
Senior Portfolio Manager

“Market volatility has been limited to equities and has not filtered through to credit assets. If credit remains in a low volatility environment, income will be king in 2018. Credit investors should consider asset classes with attractive coupon income. An example may be shifting from long-dated high yield to short-dated loans, where volatility will likely be low given the technical and fundamental picture and floating rate income. Similarly, structured credit which offers a complexity premium can offer value. “

Alex Veroude
Head of Credit, Deputy Head of Fixed Income

"In contrast to the European sovereign crisis, Italy is now an idiosyncratic story. Across Europe, the previous crisis hit countries such as Spain, Greece and Portugal are all on an improving path, reaping the rewards of structural reforms implemented after the crisis. In Italy, pension reforms were certainly a positive step, but the country failed to undertake the deeper changes needed to sustainably raise potential growth. The new government are now proposing a range of expansionary fiscal measures, cutting both income and corporate taxes and proposing a minimum citizens income of 780 Euros per month. Although more controversial measures, such as asking the European Central Bank (ECB) to write off up to 250bn Euros of Italian debt have been dropped, investors will be well aware that these were considered serious policy proposals by elements of the new government. Debt/GDP will start to rise once again and credit rating agencies are likely to start to downgrade Italian debt, in contrast to the rest of Europe where credit ratings are improving. This leaves us cautious on Italian spreads, especially in an environment where we believe the ECB will be winding down its quantitative easing purchases."

Gareth Colesmith
Senior Portfolio Manager, Fixed Income

"The global economy is evolving, shifting from a period of growth acceleration to one in which growth is moderating from elevated levels. Data, particularly European data, has disappointed relative to expectations, but poor weather has played a role in dampening activity. Looking at PMI data, most countries continue to record solid activity levels. Overall, the global growth dynamic is less supportive this year than last. Earnings growth is still solid and the outlook for equity and credit looks ok, even if in our view returns are likely to be more modest than we experienced last year. This less certain environment can present opportunities. Higher volatility has opened the door to alternative strategies that either offer a high degree of asymmetry in their pay-off profiles, or wide buffers of protection if further weakness becomes apparent. These option-based total return strategies sit well in what we see as 'late cycle' market dynamics and we have been increasing our portfolio allocation towards them."

Matthew Merritt
Head of Multi-Asset Strategy Team

"Responsible investment is no longer just a nice-to-have but a necessity. Regulations/initiatives are encouraging a sharp focus on climate change and corporate governance (examples include the European Commission's Sustainable Finance Action Plan, the UK Green Finance Taskforce, the French Energy Transition Law, the TCFD, the UK parliament's letter to the 25 largest pension funds on climate risks, and the emergence of stewardship codes in Europe and around the world). At the same time, there is increasing recognition among investors (and investment managers) that investing responsibly means taking all risks into account – including environmental, social and governance factors."

Joshua Kendall
ESG Analyst, Fixed Income

MARKET OUTLOOK

US GOVERNMENT BONDS

Isobel Lee, Head of Global Fixed Income Bonds

For the Federal Reserve, inflation, or the lack of inflation, continues to be a key factor for the interest rate outlook, keeping the bank on a gradual tightening path.

The upswing in global activity seen in recent years will ultimately have an impact on prices, but labour market tightness is yet to translate into significant wage pressure, and its our belief that this should continue to exert a limiting effect on inflation over 2018. An oversupply of rental properties in the US is also resulting in downward pressure on rents, which we believe also act to moderate US inflationary pressures.

A key risk to the inflation outlook could come from growing trade tensions. The United States Trade Representative has entered a two month consultation period on the introduction of tariffs on US$50bn of US imports from China. If these tariffs are implemented it would push inflation higher.

EUROPEAN GOVERNMENT BONDS

Gareth Colesmith, Senior Portfolio Manager, European Fixed Income

We expect core yields to resume their upward trend, as they still trade at negative yields towards the front of the curve. Continued economic strength (which will also see the effects of rising capital expenditure) and falling labour market slack will continue to exert upward pressure on yields.

We continue to believe that a strategic short duration position looks attractive. However, where appropriate, investors may wish to take opportunities to temporarily offset this with tactical or momentum-based long exposure given the potential for yields to become range-bound.

In peripheral Europe, political uncertainty will remain in Italy making either long or short positioning in the market look relatively unattractive for now.

UK GOVERNMENT BONDS

Harvey Bradley, Fixed Income

The BoE has forecast growth of 1.8% for this year and 2019, which is well below the UK's historic average but importantly above their current estimate of potential UK economic growth of 1.5%.

Given the BoE currently sees little to no slack in the economy, this gives them the bias to continue to tighten monetary policy.

The market is currently pricing in three hikes over the next 2.5 years, which is broadly in line with our forecast. The key risk however continues to be the evolution of Brexit negotiations. We believe this will also continue to keep gilts as the most volatile sovereign market in the G4.

GLOBAL INVESTMENT GRADE CREDIT

Peter Bentley, Head of Global Credit

We believe it is a time to be cautious in credit. In our view conditions do not lend themselves either to material long or material short exposure. Volatility rising closer to historically average could justify credit spreads widening more materially from their post-crisis.

It's our opinion that the fundamental picture remains very favourable, with the global cyclical upswing continuing and defaults likely to remain around record lows. A rising rate environment is also unlikely to be a threat to credit as long as yield rises remain contained and orderly. We therefore believe that a cautious and neutral or modest long position is the best strategy.

Stock selection, relative value opportunities and other alpha-generation tools we believe will be key to helping to drive outperformance in the current environment.

US INVESTMENT GRADE CREDIT

Jesse Fogarty, Senior Portfolio Manager

We are increasingly of the view that volatility may subside and will not spread to fixed income asset classes such as credit. The demand and supply picture looks tactically favourable over the coming quarter. Geopolitical risks may temper, as the North Korean threat is potentially contained and behind-the-scenes trade discussions between the US, its allies and China appear to reduce the risk of an escalating trade war.

We believe that a modest overweight bias to credit risk is appropriate. Bottom-up stock selection will continue to key to helping to drive outperformance.

EMERGING MARKET DEBT

Colm McDonagh, Head of Emerging Market Fixed Income

We remain constructive in our outlook for emerging market debt as the supportive global backdrop remains in place despite some slowing of momentum. Global growth is synchronised and robust, while sentiment indicators remain high. Signs of a downshift in global activity data may serve to slow the pace of policy normalisation in key core markets.

With respect to the US dollar, we see the potential for further weakness ahead given the extent of US structural trade imbalances and the dollar's use as a mechanism to help in the adjustment process.

Among the risks to monitor include: the ongoing electoral cycle and in particular elections in Mexico, Brazil and Malaysia, further escalation of US-China trade tensions, and other idiosyncratic risks including further deterioration in Russia's relationship with the West. Given heightened idiosyncratic risks, differentiation and selectivity will be particularly important drivers of portfolio performance.

SECURED LOANS

Ranbir Singh Lakhpuri, Senior Portfolio Manager, Secured Finance

Issuance is expected to increase in Q2, with at least 25 primary deals expected up to the end of June. Low default rates and the strong macro environment continue to bolster demand with little reason to believe this new issuance won't be easily absorbed by markets.

The evolution of loan documentation is likely to continue to be a concern for investors as issuers use buoyant market conditions to attempt to lighten covenants. The technical backdrop remains very supportive for loans with a strong bid from collateralised loan obligations (CLOs) and banks, its floating rate nature and a benign macro environment.

Credit discipline remains key with the market being unappreciative of any challenging credits especially in the context of weaker documentation and so we believe it continues to be an attractive investment for the diligent and careful investor.

HIGH YIELD

Uli Gerhard, Senior Portfolio Manager, High Yield

Fundamentals are broadly positive, and the size of the market shrank substantially in 2017 as ratings upgrades, coupon income and bond-to-loan financing more than offset new issue supply.

We continue to remain focused on short dated opportunities and have taken advantage of recent opportunities. We believe bottom-up analysis will remain central for managing risks and avoiding defaults in 2018.

One area of concern is the UK. We believe an incoherent Brexit strategy will affect the UK economy, and more importantly, that it will present UK companies with second-order risks which are out of their control. Furthermore, we expect investors to use this as an opportunity to hold short positions – given the poor liquidity in the sterling market, this could lead to significant price movements.

ASSET-BACKED SECURITIES

Shaheer Guirguis, Head of Secured Finance

The market is mostly being driven by technical factors, with demand outstripping supply, and we expect this strong technical backdrop to persist.

We continue to believe that ABS markets offer compelling strategic value given the fundament credit quality and security of the assets.

CURRENCIES

Paul Lambert, Head of Currency

The global growth outlook remains positive, and this is supportive for growth-sensitive currencies including emerging market currencies. The strength of the US economy is resulting in rising rate expectations but for now it appears that yield spreads are poor indicators of the direction of currencies including the USD. Instead, the focus appears to be other drivers of long-term capital flows, such as valuation, where the USD still looks somewhat overvalued, and the potential demand for capital that might be generated by the deterioration of the US budget and current account deficits.
As long as the focus remains on these factors it seems likely that the USD will be under downward pressure.

MARKET REVIEW AND CONSENSUS FORECASTS

Equity markets (total return, local currency)[1]

	2013	2014	2015	2016	2017	Q1
FTSE 100	18.7%	0.7%	-1.3%	19.1%	11.9%	-7.2%
FTSE All-Share	20.8%	1.2%	1.0%	16.8%	13.1%	-6.9%
S&P 500	32.4%	13.7%	1.4%	12.0%	21.8%	-0.8%
Euro Stoxx	21.5%	4.0%	6.4%	3.7%	9.2%	-3.8%
Topix	54.4%	10.3%	12.1%	0.3%	22.2%	-4.7%

Currencies[1]

	2013	2014	2015	2016	2017	Q1
GBP-USD	1.9%	-5.9%	-5.4%	-16.3%	9.5%	3.7%
GBP-EUR	-2.2%	6.9%	5.4%	-13.6%	-4.0%	1.0%

Bond markets (Bloomberg Barclays)[1]

	2013	2014	2015	2016	2017	Q1
US Treasury	-2.7%	5.1%	0.8%	1.0%	2.3%	-1.2%
US Corporate	-1.5%	7.5%	-0.7%	6.1%	6.4%	-2.3%
US High Yield	7.4%	2.5%	-4.5%	17.1%	7.5%	-0.9%
UK Gilts	-4.2%	14.6%	0.5%	10.7%	2.0%	0.1%
UK Inflation Linked Gilts	0.6%	18.8%	-1.1%	25.4%	2.4%	-0.1%
Pan European Corporate	1.5%	11.0%	1.3%	2.9%	1.9%	-0.4%
Pan European High Yield	9.9%	7.0%	2.9%	6.5%	6.2%	-0.3%

Real GDP[1]

		Consensus		Versus previous year	
	2017[E]	2018[F]	2019[F]	2018[F]	2019[F]
US	2.3%	2.8%	2.4%	0.5%	-0.4%
Eurozone	2.5%	2.4%	2.0%	-0.1%	-0.4%
Japan	1.6%	1.3%	1.0%	-0.3%	-0.3%
China	6.9%	6.5%	6.2%	-0.4%	-0.3%
Developed markets	2.4%	2.5%	2.1%	0.1%	-0.3%
Emerging markets	4.6%	5.0%	5.1%	0.4%	0.0%
Global	**3.6%**	**3.8%**	**3.7%**	**0.2%**	**-0.1%**

CPI[1]

		Consensus		Versus previous year	
	2017[E]	2018[F]	2019[F]	2018[F]	2019[F]
US	2.1%	2.4%	2.2%	0.3%	-0.2%
Eurozone	1.5%	1.5%	1.6%	0.0%	0.1%
Japan	0.5%	1.0%	1.1%	0.5%	0.1%
China	1.6%	2.3%	2.3%	0.7%	0.0%
Developed markets	2.0%	2.1%	2.1%	0.1%	-0.1%
Emerging markets	17.9%	24.1%	9.4%	6.2%	-14.7%
Global	**3.0%**	**3.2%**	**3.1%**	**0.3%**	**-0.1%**

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 31 March 2018. [E] Estimate. [F] Forecast.

THOUGHT LEADERSHIP

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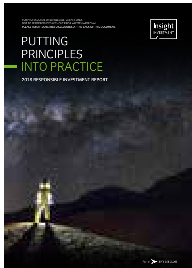


ESG: Putting principles into practice

We have developed a new climate risk model to help investors better understand the risks and opportunities that climate change introduces to their portfolios.

While our clients have been interested in our approach, there has been a dramatic upswing in their focus on climate change in the last two or three years. The reasons are obvious: the ratification of the Paris Agreement has signaled a step change in policy action and the Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) has explicitly called on asset owners to report on how they are managing climate change-related risks and opportunities.

ESG: Debunking the ESG myths in Emerging Market debt

Despite the clear benefits of ESG analysis, its adoption by EMD investors has been lacking. Investors mistakenly see ESG and EMD as incompatible, with two misconceptions typically cited.

First, governance standards for emerging market corporates are perceived as being much lower than for their developed market equivalents. Linked to this is the impression that because standards are intrinsically weak across emerging markets, ESG analysis is largely irrelevant because markets will not price in good or bad governance. Second, ESG analysis is seen as being prohibitively challenging to conduct for emerging market corporates given poor data quality, and lack of availability and disclosure of data.

We would argue that these are misconceptions.

High Yield: Managing rising rates through short dated high yield

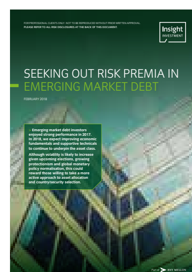
Historically low yields have led to increasing volumes of issuance with low coupons, which we view as having little chance of being redeemed before maturity. These issues are now a significant proportion of European high yield bond indices. We believe that the following strategies will help investors protect themselves against rising interest rates:

- A global approach, rather than a regional focus
- Focus on short dated and callable securities, where fundamental analysis supports the belief that there is a strong incentive for management to refinance
- Underweight longer maturity issues, especially those where there is a low incentive for refinancing such as those bonds with particularly low coupons.
- Underweight bonds in the BB credit rating category

Inflation Outlook: Focus UK

The Monetary Policy Committee (MPC) at the Bank of England (BOE) has clearly become more concerned about domestic inflation in the UK. We examine how their messaging has changed, the outlook for UK inflation and the key risks to current forecasts.

It's our opinion that in the short term inflation may moderate more quickly than expected, but the medium term outlook has deteriorated. Domestic inflation should take over as the main driver of UK inflation in 2018.



Emerging Markets: Seeking out risk premia in Emerging Market debt

2017 was a year to remember for emerging market debt investors, characterised by low levels of volatility and strong returns as risk premia compressed across the asset class.

While this is unlikely to repeat in 2018, we believe plenty of attractive investment opportunities remain, most notably in local rates and corporate debt – a testament to the breadth and depth of the asset class.

Whilst it's our view that with volatility likely to pick up over the year, we expect performance dispersion to create increased opportunity. Investors will need to be more discerning however: asset allocation and country/security selection will be crucial.

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.

FIND OUT MORE

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