Over the Wall of Worry

Fixed Income Quarterly Outlook - Second Quarter 2019

FOR PROFESSIONAL INVESTORS - April 2019

Dominick DeAlto
Chief Investment Officer - Fixed Income
dominick.dealto@bnpparibas.com

KEY POINTS

- The Federal Reserve's dovish policy pivot will extend the current expansion, and has encouraged a similar policy shift by many other central banks around the world.

- The shift is a positive for risk assets, which will also benefit from ongoing Chinese stimulus and a likely relaxation of US-China trade tensions.

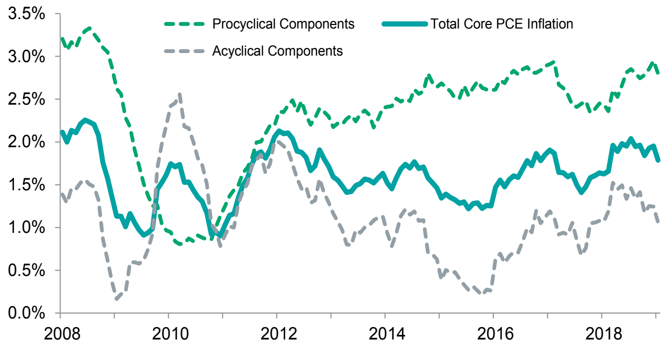
- While we believe that there is merit to being long a number of "yieldy" sectors as we open the second quarter, we are mindful that within this prolonged expansion, there have been a number of corrections that were very harmful to the risk-on trade. It is with that experience in mind that we dial back risk in some of the areas where we have enjoyed strong profits, but tactically remain invested in yield given a renewed "all-clear" signal for now.

FULL COMMENTARY

Over the last year we have written at length about prevailing market narratives and their remarkable ability to shift quickly. As 2019 began, investors took another 180 degree turn in thinking, in a manner similar to one we have encountered frequently over the past decade. On several occasions since the crisis, investors have grown concerned about slowing growth, weak inflation and the risks of overly restrictive monetary policy. Through these bouts of anxiety, central banks have relieved the tension, providing the necessary accommodation and effectively extending the economic expansion. Fear of recession was in full bloom in the fourth quarter of 2018, but again central banks (and particularly the Federal Reserve), abandoned plans for reducing accommodation and switched to a more dovish policy stance.

Still, we advise against interpreting the shift in the US monetary policy stance as a standard reaction to downside growth risks. Under the surface, there has been a significant shift in how US policymakers are thinking about inflation and managing the later stages of this expansion, with meaningful implications for markets. The shift will impact not just the policy stance this year but, importantly, the Committee's reaction function over the longer run. Specifically, having on numerous occasions incorrectly projected higher inflation, the Committee has shifted into wait-and-see mode, and will now prove unwilling to raise rates going forward absent irrefutable evidence of firming inflation. Quite simply, taking policy into restrictive territory while the Committee has missed its inflation objective for the past decade would risk a policy error that could have consequences for the central bank's independence and its degrees of freedom to navigate the next recession.

Chart 1: Core US Inflation and its Sources (YoY Change)

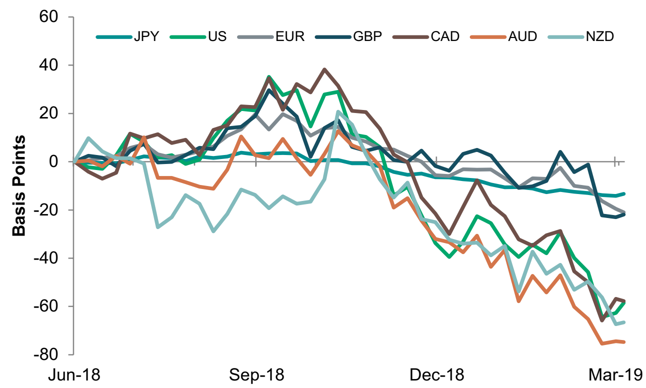


Source: BNP Paribas Asset Management, through January 2019

While the above thinking represents a tactical shift, a strategic shift is under way as well. The Committee is well aware that structurally low interest rates will make achieving the employment and price stability mandate even more challenging in the next recession, because there will be limited space to take the real policy rate far below a depressed setting of the neutral rate. In such an environment, a central bank can build up extra ammunition for the next recession by boosting inflation and inflation expectations ahead of time. With this goal in mind, next year we expect the Committee to formally shift its policy strategy away from flexible inflation targeting to average inflation targeting, with the implication that the Committee will seek to sustain average core inflation above two percent for the remainder of this expansion. Such a change represents an unambiguous dovish shift in the Federal Reserve's reaction function. With such a shift on the horizon, tightening policy in the meantime is largely off the table – higher inflation, if it were to occur, is not just to be tolerated, but encouraged. And indeed, come next year and the formal change in framework, any disinflation could lead to modest rate cuts even if growth remains around trend.

All else equal, the Federal Reserve's recent policy pivot will extend the current expansion, at the cost of somewhat higher inflation. The implications of the shift extend beyond the United States. The United States may represent a smaller proportion of global growth these days, but as the dollar remains the world's primary reserve currency and its deep and liquid capital markets draw in capital from around the world, shifts in Federal Reserve policy can influence policy elsewhere. Most immediately, the Federal Reserve's tactical dovish shift implies that emerging market central banks have greater flexibility to respond to downside growth risks of their own without engendering excessive currency weakness. Developed market central banks, meanwhile, are responding to many of the downside growth risks that have informed the Federal Reserve's pivot, but will be concerned about potential currency appreciation as US policy shifts in a dovish direction. In sum, it is not just US monetary policy that has pivoted – globally, policy rates will be lower at year-end than investors had projected just a few months ago.

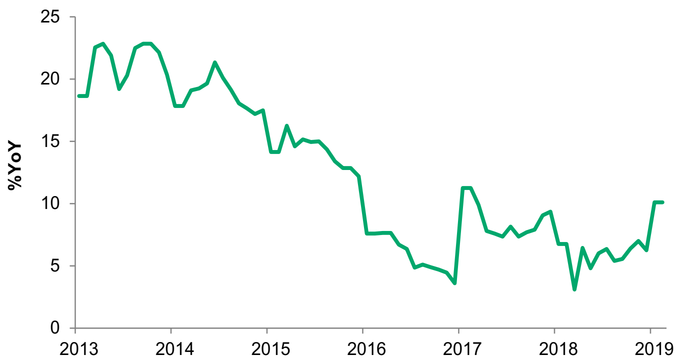
Chart 2: 3-Month OIS 2 years forward, Change since June 2018



Source: Bloomberg, through April 2, 2019

While the accommodative shift in the global monetary policy outlook should support growth and risk assets, we acknowledge that a great deal of the policy shift represented a response to intensifying downside risks to the outlook. But at the same time, we now see reasons for tempered optimism on the outlook even beyond the shift in central bank policy. Importantly, both the United States and China each have strong incentives for ending their trade dispute and removing tariffs implemented last year, even if these are phased out gradually. We expect positive news on this front before long, removing a key downside risk –and indeed, one of the primary drivers of the weakness in global manufacturing and trade over the past year. In addition, there is increasing evidence that Chinese authorities are following through on pledges to provide sufficient stimulus to keep the rate of economic growth above six percent. Green shoots in the data out of China are becoming more apparent, and as activity there picks up, export-driven economies across the globe should benefit.

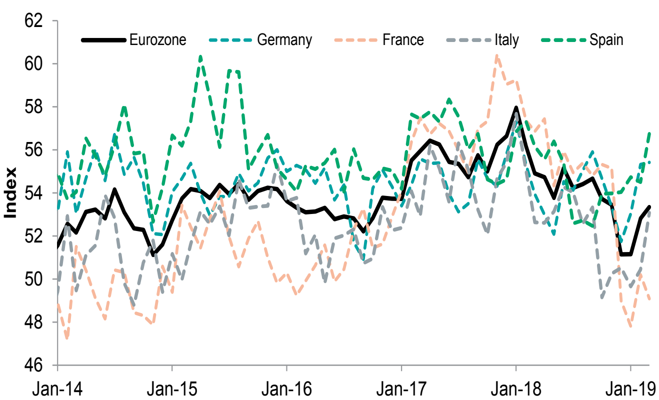
Chart 3: China Infrastructure Investment



Sources: CEIC, BNP Paribas Asset Management

Chinese stimulus should be particularly beneficial for Europe, where signals coming from the export-driven manufacturing sector are increasingly troubling. At the same time, policy space to react to any worsening in activity remains constrained, and the European Central Bank (ECB) already looks to be falling behind the curve relative to inflation expectations and the outlook for overall activity. With President Draghi's departure later this year, we are also focused on prospects that the next head of the ECB may not share the current President's "whatever it takes" mentality in navigating downside growth risks and any future stresses in the Eurozone. Still, in the near term we are encouraged by evidence that domestic demand in Europe looks to be in reasonably good shape, as evidenced by the trough in the PMI services data in January. There is little evidence that weakness in the manufacturing sector is spilling over into household spending.

Chart 4: Services PMI, National Breakdown



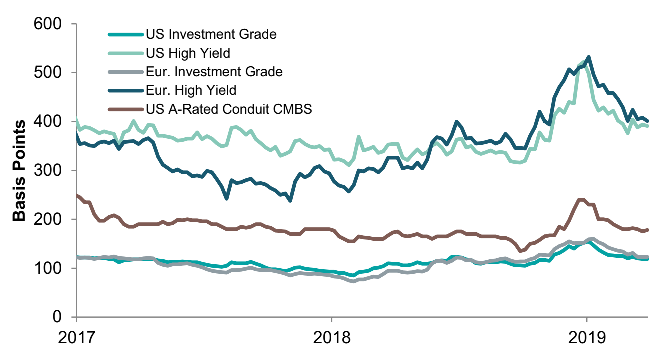
Source: Markit, Through March 2019

Taking a step back, in last quarter's missive we advised fading the global recession narrative. Looking across major economies, the stance of monetary and fiscal policy still looked accommodative, and we did not see clear signs of broad financial or economic imbalances to suggest heightened vulnerability to an unanticipated shock. Three months later, that judgement still looks correct, and if anything the shift in central bank policy, Chinese stimulus that is calling forth green shoots in activity, and the coming end to the US-China trade dispute only increases our confidence in our base case for the year ahead. Indeed, we have scaled a wall of worry. And while we may not have jumped down onto the side with the market bulls, we are at least astraddle the top. It is quite possible the shift in the global monetary policy stance will extend the expansion in major economies for the foreseeable future.

INVESTMENT IMPLICATIONS

In our last quarterly publication we highlighted our expectation for fourth quarter earnings to exhibit modest growth, albeit lower than any of the last four quarters. We discussed favorable supply technicals and finally spoke to attractive valuations in spread sectors given that the fundamental backdrop had not changed, regardless of what the sell-off narrative postulated. We suggested that portfolios with the flexibility to move into risk assets over the near term should do so. This indeed proved to be the right positioning, and many of our clients have benefited as a result. We are now presented with the question of what to do next. On one hand, it is a lot easier to own yield in this environment. On the other hand, valuations have tightened sharply, as spread sectors have enjoyed significant spread compression.

Chart 5: US and European Credit Spreads



Source: Bloomberg, through March 2019

The central bank policy pivot and signs of both fiscal and monetary stimulus out of China should and has changed investor sentiment toward yield yet again. Fading for the time being are fears of recession and central bank policy errors. Remaining is subdued growth and moderate inflation – the purported "Goldilocks" environment. And while we believe that there is merit to being long a number of "yieldy" sectors as we open the second quarter, we are mindful that within this prolonged expansion, there have been a number of corrections that were very harmful to the risk-on trade. It is with that experience in mind that we dial back risk in some of the areas where we have enjoyed strong profits, but tactically remain invested in yield given a renewed "all-clear" signal for now. We now find ourselves spending more time trying to poke holes in the Goldilocks story as a mater or precaution, while we clip coupon for a while longer.

Developed Market Duration

Despite the rally in developed market rates, it is hard to imagine a significant sell-off in government bonds absent much stronger growth data, a rise in inflation or a very unlikely series of central bank hikes. Even so, it is equally hard to imagine why one would be attracted to a 2.5 percent 10-year Treasury yield where much of the income can be wiped away with a minimal move higher in yields. 10-year Bunds and JGBs have been challenged by this calculus for years on end, and can barely compete with cash at current levels. While rates may actually finish the year lower than here, the rally has been quite swift and we believe the recent move is a bit overdone for the start of the second quarter. We look for rates to back up somewhat from here but in general should be range-bound as the year unfolds. As it is next to impossible to time small moves like we foresee, we do not expect significant positioning in G4 level duration.

In the Eurozone, we believe that growth and inflation will pick up from their recent declines but are not in a position to accelerate away to multi-year highs. This should lead core Eurozone yields to remain relatively range-bound with the risk tilted towards somewhat higher rates. We continue to prefer Spain to most other peripherals.

Inflation Markets

The FOMC's shift to a more accommodative stance, as well as its likely forthcoming adoption of an average inflation framework, support lower five-year real yields, wider breakeven inflation rates, and a steeper nominal US Treasury curve. We are positioned to capture all of these likely developments.

In the Eurozone, investors continue to doubt the ECB's ability and commitment to achieving its inflation target. Weak core inflation despite evidence of a tightening labor market, in combination with disappointing Eurozone manufacturing data, is also leading some investors to question whether the central bank has run out of ammunition. Though we have a positive baseline for Eurozone growth, the economy appears somewhat vulnerable. Over a longer horizon, if growth momentum stalls further, we see risks of markets increasingly pricing in adverse scenarios, such as deflation, given that policy rates will likely still be close to the effective lower bound and there are political difficulties associated with returning to sizable quantitative easing programs. Given low readings, we see some tactical value to be long 5-year 5-year HICP, but we do not think it is yet sufficiently cheap to warrant a strategic overweight position.

In the UK, breakeven inflation rates and real yields have been well supported by UK pension demand, as well as Brexit risk premium. In the near term, we expect the richness in UK breakevens will correct if the UK government and Parliament manage to avoid a disorderly Brexit.

Currencies

Despite the Federal Reserve's dovish pivot, the dollar has remained well supported due to poor global growth data and the concurrent dovish shift by central banks elsewhere. Thus we retain a neutral outlook for the dollar. The upside risk to our view is that the high carry in the dollar coupled with a weak external growth environment continues to attract capital flows into the US. The downside risk to the dollar is that growth indicators in the Eurozone and elsewhere begin to pick up from current depressed levels. As this is our base macro case, we may seek to build a short position in the dollar as the quarter unfolds and we see clearer signs of an improving global backdrop.

Our largest positions among G10 currencies are long the Japanese yen, the Australian dollar and the Swedish krona against a short in the New Zealand dollar and the Euro. We are bullish the yen due to the unusual divergence of the currency from the level of US interest rates, and believe the relationship can reassert itself if the recent rally in risky assets stalls. The Swedish krona remains deeply undervalued and recent economic data has held out hope for recovery, along with comments from the Riksbank detailing expectations that the krona should strengthen over the coming year, signaling some discomfort with the current level of the currency. We are bearish the New Zealand dollar as we believe that market optimism in a China-US trade deal boosting the economy is misplaced and the RBNZ will be forced to cut rates unless the global economic outlook improves substantially. We are holding this in part against the Australian dollar given extremely depressed expectations for the Australian economy and the rates outlook in that market. We are using the Euro as a funder in the portfolio given the very low carry and the disappointing economic news flow from the region.

Credit markets

In the US, we view the critical inputs as healthy for now so we remain somewhat overweight. We will likely see margin compression and lower forward guidance as the year progresses. Credit can still perform for now, but over the coming quarters, we would use this as an opportunity to improve the quality of the portfolio as there are enough late-cycle indicators in the credit cycle to suggest 2020 could prove challenging. In Europe, we are broadly long credit versus our benchmarks given a somewhat more optimistic outlook compared to market sentiment.

Emerging Markets

Our emerging market debt outlook is unusually uncertain. The team has no active beta view on market directionality now and instead issue-selection is entirely driving positioning. It also means that we are focused only on ideas that will work in both bull and bear market environments. With that in mind, we share what we believe with somewhat high conviction. The clearest call is that volatility should rise in EM assets, reflecting a still-uncertain environment and the disperse set of scenarios we are now weighing. As such we have become more selective on spreads and outright long volatility in currency space through long dated options.

As noted, emerging market central banks have taken a cue from the Federal Reserve's dovish policy turn. Previously hawkish EM central banks will similarly go on pause, and some that were raising rates last year may well try to reverse those moves. This is a very positive signal for rates generically, but there is a risk that central bank easing could weaken local currencies and have a counterproductive effect on confidence in local economies. Additionally, we note that the yield on the hard currency index is slightly higher than that on the local market index, despite the fact that historical volatility is 50% higher on the latter. This is an anomaly in the history of the asset class and suggests that risk-reward favors hard currency investments even after the recent rally.

Ultimately, we are confident that the emerging market growth picture will prove a positive for local assets. In addition, the last time the Federal Reserve implemented an extended pause, in 2006, it ushered in 18 months of unprecedented returns in EM assets. And unlike US and EU macro conditions, the growth picture for EM looks more bullish. China has bottomed and we see evidence already that Chinese growth is accelerating on a month-on-month basis so far this year. Relatedly, larger economies in Asia like India and Indonesia are looking strong. In Latin America, economies like Brazil, Colombia and Chile will double their 2018 growth rates this year.

BIOGRAPHY

Dominick DeAlto
Chief Investment Officer - Fixed Income
dominick.dealto@bnpparibas.com

Dominick is Chief Investment Officer of Fixed Income for BNP Paribas Asset Management. His responsibilities include global and regional fixed income (Europe, US, Asia), including money market funds, and global emerging market debt. He has oversight responsibility for all activities relating to the management and performance of the organization's fixed income investment teams, products and portfolios. He is responsible for challenging the strategies and processes of the various investment teams. Dominick joined FFTW, a predecessor of BNP Paribas Asset Management, in 2013 and is based in New York.

Prior to joining us, Dominick was Managing Director – Head of Product Management and Development (Americas) for Deutsche Asset Management where he served in a senior portfolio management capacity as Head of Fixed Income Asset Allocation. Prior to Deutsche Asset Management, Dominick held the position of Head of Fixed Income (Americas) for Robeco, Weiss Peck & Greer Investment Management where he oversaw the management of US and global fixed income assets. At Robeco, Dominick managed numerous fixed income multi-sector portfolios, with a focus on fixed income asset allocation. Prior to Robeco, Dominick held various fixed income portfolio management positions including fixed income portfolio manager for Chase Asset Management, a predecessor of J.P. Morgan Asset Management. Dominick began his career as a credit analyst at Chase Securities Inc. after graduating from their industry leading credit training program.

Dominick has over 30 years of investment experience. He earned his BS in Economics from State University of New York, SUNY – Oneonta. He is a member of the New York Society of Securities Analysts and the CFA Institute.