Goldilocks and the Three Bears

Fixed income quarterly outlook - third quarter 2018

FOR PROFESSIONAL INVESTORS - June 2018

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Key points

- Three themes have emerged to challenge the Goldilocks narrative that supported risks assets through the second half of last year - signs of diverging growth across major economies, a stronger US dollar, and material risks of a broadening trade war
- These "three bears" are likely to make for a much more challenging environment for risk assets going forward
- Indeed, while we some interesting opportunities, markets remain fragile and susceptible to heightened volatility

Full commentary

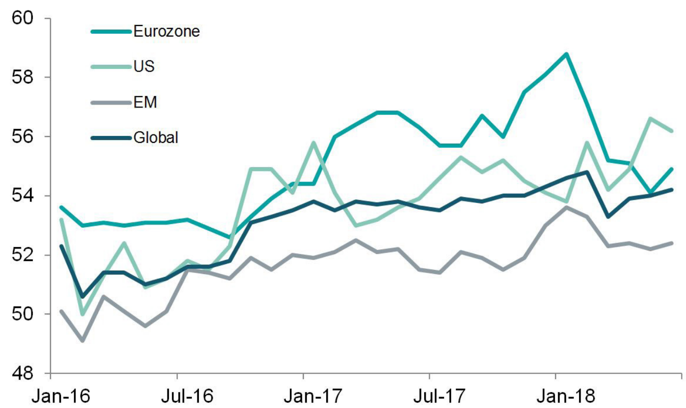
As 2018 began, the consensus market narrative was centered around a Goldilocks scenario characterized by synchronized strong global growth and modest inflation pressures. This macro backdrop, combined with still-accommodative monetary policy in developed markets, was expected to support continued solid performance of risk assets. As we discussed in our second quarter outlook, we were then in the throws of a test against this market narrative. Strong US inflation prints led to a recalibration of monetary policy expectations as the second quarter began. This resulted in a spike in bond yields that ultimately weighed on global equity performance. As equity volatility rose, quantitative trading strategies were forced to cover short volatility positions across markets. This set off a negative feedback loop that led to further spikes in volatility measures, and served to exacerbate the downturn in equities and other risk assets. Despite a tumultuous opening to the second quarter, the dust settled on the event, and the adjustment to a steeper expected policy rate path has been relatively smooth.

One could have expected a swift return to the Goldilocks narrative after this event. However, three events seem to have put the basic assumptions of this long standing thesis to the test. First, global trade frictions have increased as threats of tariffs from Washington were met with defiant responses as the Trump administration alienated supposed trade rivals, as well as some of the United States' closest allies. This ignited a concern that there could be a re-calibration of global growth and corporate earnings forecasts. The sell-off in equity and spread products returned, this time with greater breadth as asset classes and industries that survived the volatility event (for example, emerging market debt) saw interest and liquidity begin to evaporate. To add to Goldilock's challenges, economic data released during the back half of the second quarter pointed to stronger US growth vs. weaker growth in Europe, China and the rest of Asia. This shattered the market belief in synchronized global strength.

In sum, "three bears" have emerged to chip away at the Goldilocks narrative – new signs of growth divergence across major regions, a stronger dollar, and increasing risks of US protectionism. Taking these in turn, strong growth momentum across major economies has indeed come under scrutiny and had been found wanting. The Eurozone, which had perhaps been the lead character in the growth acceleration story of 2017, has experienced a significant softening in activity indicators which has now begun to shine through to the hard data. Japan has also experienced a loss of momentum, as have some large emerging market economies. And in China, official efforts to rein in leverage in the state enterprise and local government sectors have led to a slowing of activity, prompting the central bank to cut reserve requirements in a targeted effort to support smaller enterprises.

Resilience in the US economy may be encouraging while growth disappointments emerge elsewhere, but that resilience also contains risks. For markets, a "tightening tantrum" similar to the first quarter yield spike could easily be repeated. Markets are still underpricing the Federal Open Market Committee's (FOMC) resolve to move gradually towards a restrictive policy stance next year. If US protectionism fears fade and inflation continues to firm, the 10-year Treasury yield could easily move back above three percent quite rapidly. It is the speed of such a change that would certainly impact risk assets yet again. As we have learned far too many times, it is the slope of change rather than the terminal rate that matters the most when it comes to the pricing of credit and other risk premium spread products.

Figure 1. Emerging and developed market composite PMI indices



Source: Bloomberg

Bear number two is the reversal in the US dollar (USD) relative to the euro, sterling, and much of the emerging market (EM) space. To be sure, the 2017 call for a weaker dollar always seemed questionable given that the Federal Reserve (Fed) was well ahead of the rest of developed market central banks in removing both traditional and quantitative easing measures. Despite this, the broad consensus was that an aging US cycle and long-term debt sustainability issues would lead to a structural decline in the dollar. Now, higher short-term US rates have transformed the US dollar from a funding currency to a carry trade, leading to a resurgence of dollar strength. The short position in USD was significant going into 2018, but it reversed at the beginning of the second quarter when the divergence story began to take shape. As the US continues to strengthen in relation to other economies, investors continue to cover dollar shorts.

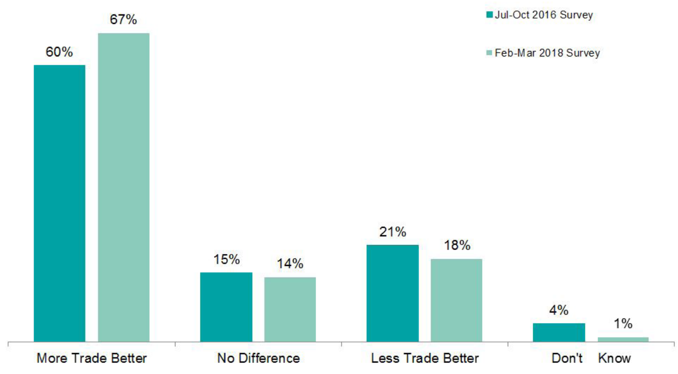
Our third bear is US trade policy and the increasing tensions it is generating with major trade partners. We have never doubted the Trump administration's desire to revitalize the US manufacturing base and reduce bilateral trade deficits, using tariffs as a form of negotiating leverage but also as a means for achieving these goals if necessary. We have also appreciated the resolve of other nations to safeguard international rules and norms that support free trade as well as the political necessity of retaliating against US tariffs.

Unfortunately, trade tensions will only escalate in the months ahead. A key reason is that all sides believe they have the upper hand in negotiations. Most notably, the US believes that the sheer size of bilateral goods deficits with the European Union and China, as well as the greater importance of exports as a growth engine for those economies, provide significant negotiating leverage. Strong US growth and Trump's high level of support among Republicans also underlie the administration's negotiating strategy of demonstrating a willingness to incur short-term costs in trade fights. There may be some logic to the administration's thinking, but as it is fighting on numerous fronts at the same time, it is likely overplaying its hand.

When it comes to specific trade clashes, it is challenging to see a clear path to resolution any time soon. Issues regarding China's intellectual property practices will prove difficult to resolve to both parties' satisfaction. China has a strong incentive to insist on foreign technology transfer as part of the "Made in China 2025" strategy that aims to transform China's high-tech, high value-add industries into global leaders. Meanwhile, the US increasingly sees this objective as a long-term strategic threat, and is unlikely to give in on its core demands. As to NAFTA, a unified negotiating position between Mexico and Canada will make it difficult for the US to make headway on its demands for higher North American content and a sunset clause, increasing the chances that the administration will signal its intent to withdraw from the agreement in an attempt to gain leverage in negotiations. Finally, the Trump administration's newfound focus on trade in autos could prove equally challenging to resolve. At the very least, we doubt the US will be willing to drop its high tariffs on truck imports – a likely demand from the European Union.

In addition, businesses may abstract from the implementation of US tariffs against China that tariffs against other nations, along with retaliation, are increasingly likely. This may lead to a fall in business confidence that adversely affects hiring and investment decisions and will ultimately weigh on growth. Increasing risks of a broader trade war will also impact the stock market, further weighing on household and business spending. A full-scale trade war, characterized by high tariff barriers and an unravelling of global supply chains, may very well be avoided. But if businesses and households simply assign a higher probability to this outcome, it could still have a deleterious effect on the global economy.

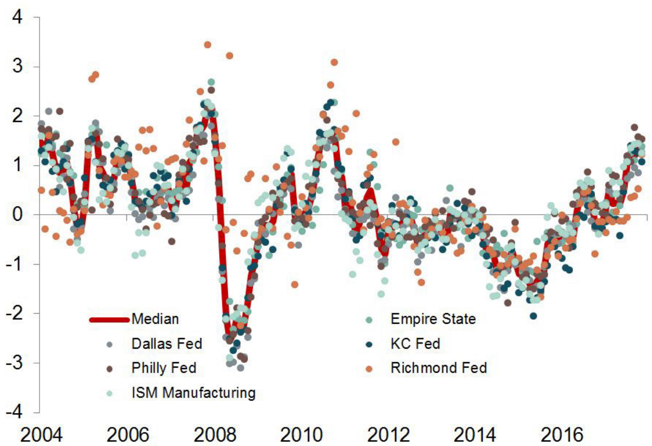
Figure 2. Would More Trade or Less Trade with Other Countries Be Better for the U.S. Economy?



Source: University of Michigan Survey of Consumers

Absent in the fable, but very real in today's story, would be a "fourth bear", which is inflation, particularly in the US. Risks are indeed skewed to the upside in light of sustained above-trend growth, building wage pressures as firms wrestle with the growing shortage of skilled workers, and mounting signs of rising non-labor input costs. This fourth bear may be dormant for the time being, but the state of the business cycle and accommodative monetary policy suggests this may not last indefinitely.

Figure 3. Prices Paid Components of Manufacturing Surveys



Source: Federal Reserve Banks of New York, Philadelphia, Kansas City, Dallas and Richmond, June, 2018; Institute of Supply Management, June, 2018

To better illustrate the many assumptions and market held beliefs and how they have changed since the start of the year, we present the following illustration:

Figure 4. Market Held Beliefs Then and Now (Jan 2018- June 2018)

From		To	Timing
Rising global PMIs	➡	Falling global PMIs	Now
Sideways inflation	➡	Rising inflation	Now
Inflation below US Fed target	➡	Inflation at US Fed target	Now
Positive policy catalysts	➡	Harmful policy catalysts	Now
Market outperforms the economy	➡	Economy outperforms market	Now
Risk parity trades do well	➡	Risk parity trades struggle	Now
Govt. bonds diversify well	➡	Govt. bonds diversify poorly	Now
FI spreads expensive, but w/ good momentum	➡	FI spreads expensive w/ poor momentum	Now
Persistent sector leadership	➡	Lack of sector leadership	Now
Growing Central Bank balance sheets	➡	Shrinking Central Bank balance sheets	Now
Risk models signaling all clear	➡	Risk models signaling caution	Now
Rising corp. profit estimates / EPS growth rate	➡	Peak in profit estimates / EPS growth rate	3Q18
Fed funds below neutral rate	➡	Fed funds at / above neutral rate	3Q18

Source: BNP Paribas Asset Management

Positioning assumptions and implications

As we think through our strategies for the third quarter, we find it necessary to state that despite the challenges expressed above, not all of them are particularly worrisome. Global growth remains on a sound footing, at least by the lower standards of the post-crisis era. The closely-followed PMI indicators still signal a solid global expansion despite having recently shown signs of leveling off. North Asian export data, normally a good leading indicator of world export volumes and hence aggregate demand, have also strengthened as of late. As for central banks, most remain cautious as they back away from the ultra-accommodative policy of the post-crisis period. The European Central Bank (ECB), for example, has signaled that the tapering of its asset purchases will be followed by an extended period, possibly stretching into the fourth quarter of 2019, of an unchanged policy rate. In addition, any meaningful change to the Bank of Japan's yield curve control policy seems quite a ways off. And the Fed has chosen to largely accommodate fiscal stimulus, accepting the risks of a sustained inflation overshoot in exchange for a prolonged expansion. But even with this in mind, it would be disingenuous not to admit that the global synchronous growth narrative has been replaced by one in which a fiscal-fueled, and higher leveraged US economy has moved to the front of the pack. Whether that fuel turns to fumes sooner rather than later, or the US expansion gets a second wind due to higher productivity and trend growth, remains to be seen.

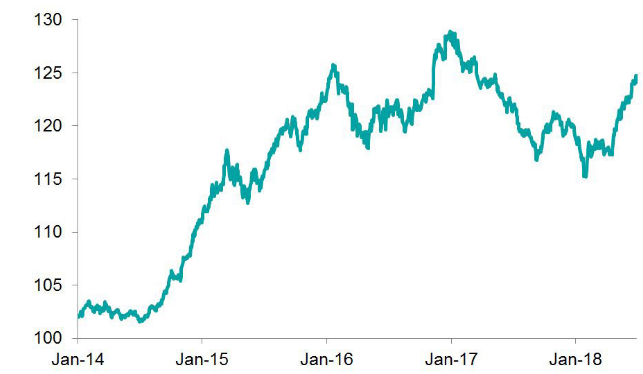
Emerging Market Debt - The US policy mix of fiscal stimulus and gradually tightening monetary policy has caused a significant shift in the Goldilocks narrative for emerging market assets. The resulting capital outflows have led central banks in many emerging economies to opt for a tighter monetary policy stance than warranted by the growth backdrop, in an effort to support the domestic currency and keep inflation well-contained. Emerging economies with large current account deficits and high levels of dollar-denominated corporate debt have been particularly susceptible to outflows and currency weakness. Fortunately we reduced risk in the space four months ago, and we expect this adverse environment for emerging market fixed income to continue. While we are attuned to the risks that protectionism, US inflation surprises and any continued slowing in China hold for the asset class, valuation has arguably re-entered the zone in which we begin to take closer notice. This is particularly the case in multi-sector unconstrained and absolute return strategies where relative value to other asset classes is of particular interest. Before we move back into the asset class broadly, we will need to see three conditions met:

1. **USD Short Positioning:** We are nearly there. Technicals are key, especially in FX — our first criterion was that the large short USD position should be cleaned out prior to considering a new investment. The data began to show an improvement in short dollar positioning in May, with surveys reflecting a neutralization of Latin American and Asian FX investments. The tariff threats between the US and China further helped shift positions, with the market building a USD long against Asian FX by early June. The euro was the last shoe to drop, and ECB communications of no rate hikes until late 2019 finally triggered significant covering of the Euro against the USD. Surveys show managers are still long EMFX on a net basis, however the month of June witnessed the largest drop in long positioning in several years. Indeed, we have tactically begun to take select investments in some oversold currencies, especially in Asia.
2. **EM Growth Thesis:** Not yet convinced. Our second criterion surrounds the trajectory of emerging markets growth. EM data going back to April suggested a pause in EM growth acceleration, and by the beginning of June we saw a full-on slowdown in nuts-and-bolts indicators such as trade volumes and industrial production. We have been watching constantly for real time signs that growth is recovering, particularly in leading markets such as East Asia and in previously overheating Eastern Europe. To date we have seen nothing that gives us strong confidence that the slowdown has ceased, however neither do we see a recession yet in view: so far, we

are calling this a “downshift.” In light of the trade war threat, we consider it even more important to wait for signs that growth will recover prior to drawing a directional conclusion.

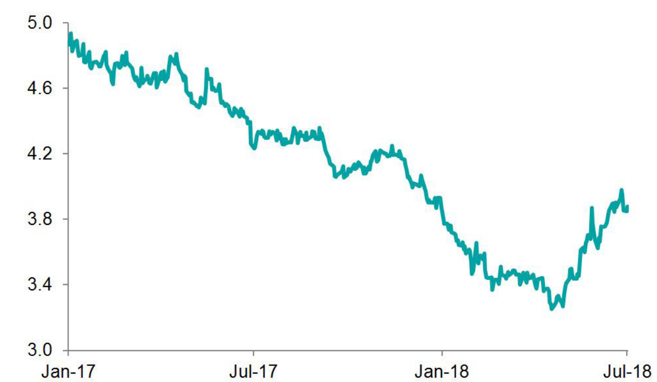
3. **A Reprieve from Rising US Rates:** Not even close. The root cause of the current market rout in emerging markets is the divergence of cycles between the US and the rest of the world this year, which has pushed up US interest rates and inflation expectations, more or less, in isolation. Inflation risk spells continued US central bank rate hikes which, in combination with balance sheet runoff, reduces liquidity from global markets and could further capital outflows from emerging markets. At the moment, risks remain skewed toward a continued environment of strong US growth, higher US inflation, and an upward march in US interest rates. We don’t yet see relief from this scenario on the horizon. All roads lead back to the Fed, and US tightening remains the biggest risk to EM asset recovery.

Figure 5. Broad Trade-Weighted US Dollar



Source: Federal Reserve Bank of New York

Figure 6. Local Currency EM Bond Index Yield Spread to 5-Year US Treasury



Source: J.P. Morgan, Bloomberg

Global Corporate Credit - Looking out over the rest of summer, and indeed the rest of the year, there are a few investment themes we see materializing. Global corporate spreads have widened in the first half of the year as a result of US tax repatriation, decreased foreign demand, and political headlines both in the US and Europe. While there are pockets of slowing global growth, near-term recession risks remain low. Therefore we expect M&A-related activity will continue in both the US and Europe, which could put pressure on BBB-rated issuers and longer maturity spreads. Given this backdrop we expect short dated US Investment Grade bonds to perform well. This sector is currently at its highest post crisis level of yields. In Europe we expect some further spread widening as the region adjusts to the slowing growth narrative, political headlines and the inevitable end of ECB asset purchases. As it relates to High Yield, we prefer the US region over Europe as stronger growth and reduced issuance allow this sector to perform. In Europe, we are starting to see some issuer stress as a result of profit warnings and news of tariffs, and the weakest issuers are facing higher refinancing costs as investors demand additional credit risk premium.

US Agency Mortgage Backed Securities (MBS) - Valuations have cheapened year to date and look attractive. We are looking for entry points for a tactical long versus Treasuries. Strong relative performance of MBS versus credit should also continue. We see the MBS sector as offering attractive yields for a shorter duration, higher quality and more liquid asset class. Higher mortgage origination rates have led to a slowdown in refinancing supply which is offsetting somewhat the reduced demand coming from the Federal Reserve’s balance sheet normalization.

In credit sensitive residential mortgage backed securities Credit Risk Transfer (CRT) spreads moved wider during the month on new supply concerns and overall market volatility. Fundamentally, the outlook is positive for residential credit as delinquencies trend lower, home prices move higher and unemployment remains very low. Commercial Mortgage Backed Securities (CMBS) spreads have been stable despite equity market volatility and a robust June supply calendar. Commercial real estate property prices continue to move higher for all asset types apart from retail shopping centers. Credit performance in CMBS remains strong with rising rents and low vacancy rates. We maintain overweight in CRT and in CMBS.

Biography

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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 28 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.