Continental Europe

Fixed Interest 2019 Outlook

Stuart Edwards,
Paul Read,
Julien Eberhardt
Fixed Interest,
Henley

Key takeaways

- 2018 saw a re-pricing of some parts of the bond market, which has created some value.
- Fundamentals within the banking sector generally remain good heading into 2019.
- Challenges remain that could see further volatility and potential investment opportunities during 2019.

Stuart Edwards

As we look ahead to 2019, the US economy is, in my view, in pretty good shape. However, with the fiscal stimulus that has been such a driver of recent growth coming to an end and trade tensions an ongoing concern, economic growth has likely peaked and could now fade. Meanwhile, despite the structural arguments one could make for inflation to increase, we are, so far, yet to see any meaningful pick-up in the rate of inflation.

Against this backdrop, the US Federal Reserve is three years into its current hiking cycle. As US yields have adjusted to a higher Fed Funds rate, so too has the balance of risk and return for US government bonds. That is not to say that yields might not rise further than current levels – clearly, they could. Rather, the compensation for taking US duration risk has increased making the US a potentially competitive source of income. In turn, this has led investors to demand a higher premium to invest in more challenged areas of the fixed income market. At times over the past 12-months this re-pricing has created opportunities that we have sought to exploit.

As the challenges of tightening monetary policy and global trade play out over the coming year, I would expect further tactical and strategic investment opportunities to present themselves. The flexibility to be able to exploit such opportunities will, I believe, be important to delivering returns in what could be another difficult year for bond markets.

Paul Read

I think 2019 will initially be a continuation of what we have seen in 2018. The Federal Reserve look set to continue their policy of gradually tightening US monetary policy. Meanwhile, uncertainty over trade, the Italian government's budget deficit, Brexit and emerging markets remain potential catalysts of further volatility.

While I remain cautious, I am slightly more constructive on the asset class than I have been in previous years.

That said, I think we begin 2019 with bond markets better placed than they were at the start of 2018. The volatility of the past 12-months has seen some value come back into parts of the market and as a result there are now some relatively attractive yields that can be found. This not only helps when we're trying to get income for the funds, but it also means that there is now more of an income cushion during periods of price volatility.

One area where I believe the re-pricing has created some value is the AT1 market and I have, where appropriate, been seeking to add exposure. Elsewhere, the rise in US yields is a positive for US corporate bond markets. Currently, I think the best opportunities within this market can be found in bonds maturing in 7-10 years, but if US yields move significantly higher, then this could start to open-up opportunities further out the curve.

Summing up, I don't think we are yet at a point where we can say the market has become cheap, but I do think we can probably say that the market has become more rational. I think there is a sense that the balance has started to tip away from borrowers and toward us as investors. So, while I remain cautious, I am slightly more constructive on the asset class than I have been in previous years.

Julien Eberhardt – Financials

Our largest sector allocation in corporate bonds remains financials. Before thinking about the prospects for the sector in 2019, I think it is helpful to reflect on what has happened to financials over the course of 2018. At the start of the year, the financial sector was very popular with investors owing to the sectors attractive level of yield versus other parts of the market. After a strong start, a series of exogenous factors began to impact on the sector in late January/early February leading to significant re-pricing as the market sought to reposition.

Alongside concerns over US interest rates, trade, the Italian budget and Turkey were money laundering concerns within Nordic banks, uncertainty over the treatment of stamp duty in Spanish property transactions and whether or not banks should pay the charge, Deutsche Bank's profit warning and a change in its CEO, Aviva's threat to cancel preference shares it had previously described in marketing material as irredeemable, HSBC's reclassification of £2bn worth of discount perpetual floating rate securities (DISCO bonds) to tier 2 capital – a move which saw the bonds lose around 20% of their value and the ECB's commitment to not hike interest rates until at least summer 2019.

Despite all of this, fundamentals within the banking sector generally remain, in my view, good. Italian banks have continued to reduce the amount of non-performing loans (NPL) on their balance sheets. Meanwhile, asset quality within the banking sector has continued to improve. What the past twelve-months has done is to bring some value back into the market. AT1 bonds and Bank equity are now significantly cheaper and, in my view, offer value. From a top-down perspective, the sector should receive further support if the ECB maintains its current path and starts to tighten policy in 2019. But, Brexit and Italy remain two significant risks for the sector and are areas we are closely monitoring. As has been the case this year any further periods of volatility would, all else being equal provide an opportunity to increase exposure.

As the challenges of tighter monetary policy and tensions over trade play out over the coming year, I would expect further tactical and strategic investment opportunities to present themselves.

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