The Investment Environment Is on the Verge of Rotation

Neglected assets may be set for a comeback.

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Ken Orchard
Portfolio Manager,
Global Multi-Sector Bond Fund

Sentiment toward the global economy is beginning to shift. So far this year, the focus has been largely on recession fears and central bank easing, which has been good for long-duration assets such as high-quality government bonds, investment-grade (IG) corporate bonds, and BB rated high yield bonds. Fears over a recession are beginning to diminish, however, and while central banks are likely to continue easing, there is a limit to how much further they can go. There may be one more cut from the Federal Reserve (Fed) after October's meeting, but I suspect that will be it. The European Central Bank is constrained: It may cut rates by an additional 10 basis points or so, but it will be concerned about collateral damage on the banking system. So central bank easing could soon give way to a quiet period in which rates remain on hold.

We're just at the beginning of this period of change. There is understandably still a lot of caution out there, but recent positive developments in U.S.-China trade talks have boosted confidence. While many international organizations are still cutting their economic forecasts, our economics team recently upgraded its predictions for European and U.S. growth next year, predicated on easier financial conditions, which have eased materially over the past 12 months.

One of the most likely manifestations of this could be a steepening of the yield curve as future inflation expectations rise. This will probably mean that long-duration bonds, such as high-quality sovereigns, will begin to perform less well. Investment-grade companies in stable countries, which have been widely owned while investor sentiment has remained cautious, may also begin to fare worse than other asset classes as optimism returns.

What will perform instead? Most likely, the assets that investors have been avoiding for the past year or so. These include single B and CCC rated high yield bonds, which have underperformed the BB space this year and could start to outperform higher-quality credit investments as people may begin to venture into riskier asset classes.

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Loans also look interesting. They've not done too badly this year, but they've underperformed most other spread sectors because they have no duration and so have not benefited from falling yields. As the markets become more positive on growth and begin to think about when the next Fed hike might come, loan prices will likely rise again.

Although inflation is currently muted in most countries, unemployment is also low and business investment has been weak, so inflation may start to rise again. If it does, Treasury inflation protected securities may do well. I would expect the U.S. dollar to decline in this environment, but that is a more difficult call.

The main risk to growth is probably U.S.-China trade talks deteriorating once again. However, as things stand, it seems like both sides want to at least maintain a truce through 2020. If that holds, growth is likely to recover—and a rotation in outperforming assets can be expected.

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