



## POLICY INSIGHTS

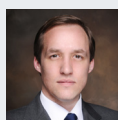
June 2018

*The view from our  
fixed income experts.*

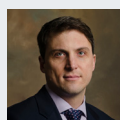
### GLOBAL INVESTMENT TEAM



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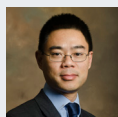
Andrew  
Keirle



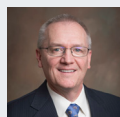
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*Once a month, our fixed income experts, helped by our analysts and traders, conduct an in-depth review of the full fixed income opportunity set. This article highlights a particular theme that dominates markets today.*

# 2018: The Year When Consensus Trades Have Not Paid Off (So Far)

Consensus trades have been severely tested by markets so far in 2018. It began at the beginning of the year, when many investors piled into global stocks on the back of strong global growth data—only to pay the consequences when there was a sharp correction in February. Another popular trade to be challenged was being short the U.S. dollar as the DXY index rose 4.5% in April and May. Emerging market (EM) bonds and currencies were hit next, as the market fretted about rising oil prices and higher U.S. yields. A fourth major consensus trade—short duration—arose as the market braced itself for global rate hikes, but this too has had limited success so far as inflation has remained stubbornly subdued. Finally, many investors saw the eurozone periphery as a place to hide from rising global yields, but this thesis was destroyed by the return of Italian political risk at the end of May.

During our latest Policy Week meetings, our global investment team took a close look at these trades and reflected on whether other consensus trades may be at risk—or continue to offer opportunities.

The emerging market consensus trade was arguably the most painful one. Having waited for many years to get back into emerging markets, many investors took advantage of the rally in commodities to increase their allocations to developing economies—flows were

positive from the beginning of the year until April, particularly in EM equities. “The demand for EM assets created its own momentum, convincing market participants to allocate more to the sector,” said Ken Orchard, portfolio manager and member of the global investment team. “But the rapid rise in oil prices then led to concern about higher inflation and wider current account deficits in countries such as Argentina and Turkey, sparking currency depreciation and significant outflows.”

**“The demand for EM assets created its own momentum, convincing market participants to allocate more to the sector...”**

—Ken Orchard, Portfolio Manager and Member of the Global Investment Team

However, this has created an opportunity to buy currencies that have become undervalued since the sell-off, Orchard noted. “Oil-related commodity currencies

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—Ken Orchard, Portfolio Manager and Member of the Global Investment Team

stand out in this regard, particularly the Russian ruble and the Colombian peso,” he said. He added that some local bonds have also been overly punished in the EM correction, citing the local debt of Brazil, whose local five-year bond is trading at 10.75% at a time when the key lending rate is 6.5% and inflationary pressure is low.

The failure of the short-duration consensus trade has led many investors to cut their positions—but this may prove to be premature, according to Orchard. “Now is not the time to give up on inflation,” he said. “The effect of rising oil prices was delayed and is only now starting to show, as seen in

the latest German inflation print [which was its highest level for a year]. At the same time, the Federal Open Market Committee noted in its latest minutes that it expects economic conditions to justify further gradual rate increases.” The global investment team concluded that remaining underweight duration in high-quality countries is still justified in the current environment.

Looking ahead, the most obvious candidate for the next consensus trade to hurt investors is the long credit positioning that has accumulated since the financial crisis. But it is not clear when a correction could occur, or what might trigger it. According to Orchard, the recent

emerging markets correction could serve as a useful road map. “A combination of steady outflows, coupled with a succession of negative idiosyncratic stories, would cause a major correction in credit markets,” he said. “Although this scenario does not appear to be on the immediate horizon, we remain cautious and focused on our bottom-up research to find good companies.”

The derivative sector may offer a guide to future periods of volatility. “It was interesting back in February to see synthetic indices underperform corporate cash bonds during the equity market correction, especially as it was followed by a material widening of cash bond spreads,” Orchard said. Investors were initially reluctant to sell their allocations to credit securities and have been using derivative instruments to manage the short-term credit beta in their portfolios, he explained. The team concluded that synthetic indices and options are likely to be the most effective way of expressing tactical defensive views on corporate bonds at present.

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