



Will the Reflation Theme Continue in 2020?

A closer look at how fixed income markets could perform this year.

January 2020

KEY INSIGHTS

- Economic rebound still fragile as hard data continues to be soft.
- Dispersion in performance of credit markets likely to continue.
- Environment for emerging market countries supportive, but headline risks remain.

What's in store for fixed income markets in 2020? If the market consensus is anything to go by, the reflation theme looks set to continue. This was a key discussion point during our latest policy meetings, where the investment team took a deep-dive look into the macro environment to assess whether the

conditions will continue to benefit risk assets this year—or whether investors should exercise some caution.

Don't Get Carried Away Yet With the Recovery

The improvement in global growth over the last few months has not gone unnoticed by central banks—several,

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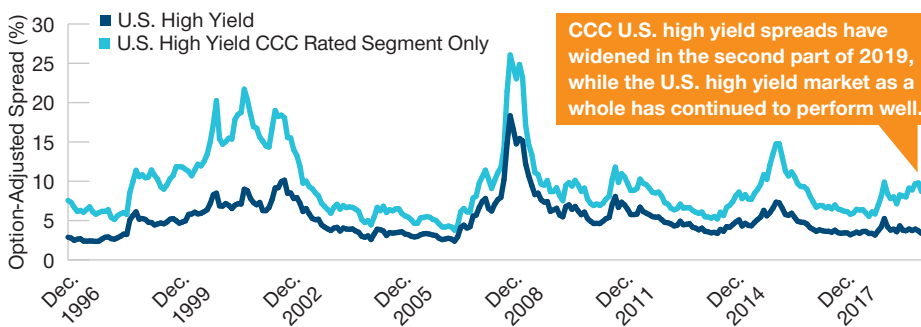
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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

(Fig. 1) Is CCC Rated High Yield Sending a Warning?

Option-adjusted spreads (%) for the CCC rated segment of the U.S. high yield market and the U.S. high yield market as a whole.

As of December 31, 2019



Bloomberg Barclays U.S. Corporate High Yield Bond Index.

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— Arif Husain
Portfolio Manager and Head of
International Fixed Income

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including the Federal Reserve, have acknowledged the stabilization in economic conditions. This has resulted in gains for risk assets, such as equity and credit markets, while core bonds have struggled.

“Markets are full of optimism over the outlook for growth—a lot has been priced in,” said Arif Husain, portfolio manager and head of International Fixed Income. However, he added: “Although it’s certainly true that the global economy is on firmer footing right now, not all indicators have turned green yet, and hard data continues to be on the soft side.”

The investment team noted that, although the worst may be over, the recovery remains tentative. In the eurozone, for example, growth remains tepid across most countries. “It may feel like a victory to see European PMIs rise again, but it’s only been a modest improvement so far, which means that investors probably shouldn’t get ahead of themselves,” said Mr. Husain.

The geopolitical environment also poses risks. Even though the environment has improved over the past few months, supporting investors’ risk appetite, circumstances can change quickly. “There are lots of events in 2020 that could cause the geopolitical pendulum to shift in the opposite direction,” Mr. Husain said. He cited the recent escalation of tensions in the Middle East, the implementation of Brexit, the U.S. presidential election, and ongoing U.S. tariff negotiations not only with China, but also potentially with Europe.

Further Dispersion in Performance of Credit Markets Likely

Turning attention to credit markets, there have been some mixed signals recently. For example, while corporate bonds performed well in the second half of last year, the cost of short-term

insurance on U.S. investment-grade companies started to rise. Furthermore, while high yield spreads have tightened overall, spreads on energy companies and the riskier C rated segment of the market have significantly lagged the tightening of non-energy companies and higher-rated bonds in the BB and B categories. “The trend of bifurcation in high yield could continue in 2020,” Mr. Husain said. “Investors are being more selective in the way they want to take risk at this late stage of the cycle.”

In emerging markets, the environment is broadly supportive, although there are a number of idiosyncratic challenges that both local currency and hard currency bonds could face this year. Mr. Husain said: “There is a lot of uncertainty out there—and potential for significant headline risks in 2020.”

Within frontier emerging markets, the situation is even more critical because access to liquidity can often be strained, resulting in rapid, large price dislocations when there’s a risk event. Last year, the most extreme example of this was Lebanon, where protests triggered a significant sell-off in domestic government bonds. “It will be important for countries like Sri Lanka, Zambia, and Ecuador to avoid a similar negative spiral in 2020,” Mr. Husain said.

Solid Growth Needed for Risk Rally to Continue

For the rally in risk assets to continue, the reflationary scenario needs to turn into a solid growth story. But it is clear that there are lots of hurdles to overcome before that can play out. Against this backdrop, investors should take a cautious approach when considering adding risk into portfolios so late in the economic cycle. “The ability to dial risk up and down at different times during the year will be key in making 2020 a successful year for fixed income investing,” said Mr. Husain.

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