Dominick DeAlto, BNP Paribas Asset Management

Dominick DeAlto is Chief Investment Officer of Fixed Income for BNP Paribas Asset Management globally, based in New York. Dominick joined BNPP AM predecessor FFTW in 2013. He has over 28 years of investment experience having previously worked at Deutsche Asset Management, Robeco, Weiss Peck & Greer Investment Management and Chase Asset Management. 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.

AS GOOD AS IT GETS?

Fixed income quarterly outlook - second quarter 2018

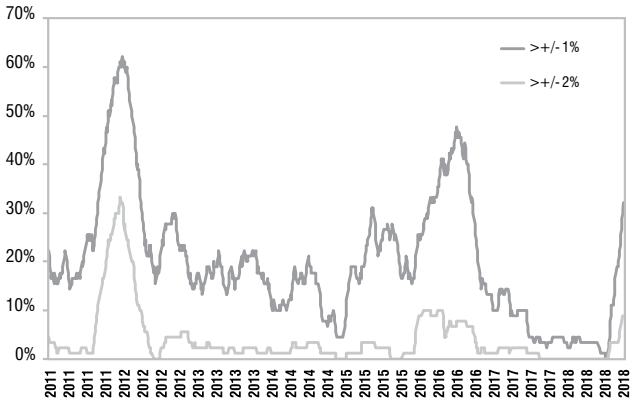
Dominick DeAlto

Key Points

- As markets already fully discount a solid year for global growth, it is challenging to see scope for upside surprises at this point.
- If anything, some modest cracks in economic momentum have turned investor focus to downside risks.
- With the Federal Reserve showing greater resolve to tighten policy, and other major central banks likely to follow suit over time, expect heightened volatility ahead and a rebuilding of risk premia.

What a difference a quarter makes. When I last wrote in January, we remained cautiously risk on, but extremely nervous in the process. As I noted at the time, we saw risks that a change in the inflation outlook could "cascade throughout the system to affect policy, yields and the complacency that envelops all asset classes." Since then, that complacency has been sorely tested, as firm US inflation readings prompted a steepening of the expected path for the policy rate and a rise in long-term interest rates. But an evolving policy rate outlook has been just one catalyst for the uptick in market volatility. Investors have also grown increasingly concerned over the Trump administration's "America First" trade agenda, as well as a potentially less favourable regulatory environment for the US technology sector after a handful of high-profile events shook investor confidence in a couple of leading tech firms. Some cracks in the narrative of synchronised global growth have further added to the wall of worry in markets. Given these factors, it is unsurprising that investors have demanded additional compensation for holding risky assets.

Figure 1. Percent of Trailing 90 Days with Large Up or Down Moves in the SPX



Source: Bloomberg, BNP PAM

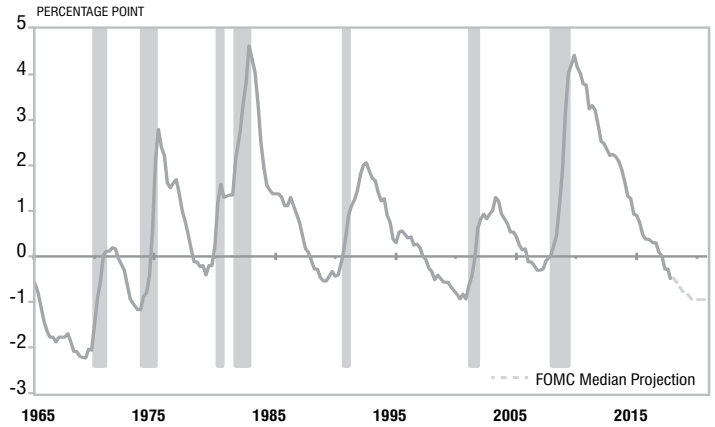
The quote

With the Federal Reserve now showing greater resolve to tighten policy, asset valuations may be vulnerable and risk premia should rebuild.

As a firm we have written extensively about the Trump administration's growing trade dispute with China, their hard line on NAFTA and the considerable collateral fears they have fueled. There are clear challenges ahead as China and the US hammer out fundamental differences on technology transfer and intellectual property protections, but for the time being we remain cautiously optimistic that the two sides will delay implementing tariffs so that negotiations have ample time to bear fruit. This will be a slower-moving train than headlines, and presidential tweets, would have us believe.

Given our generally sanguine view on trade policy outcomes, we are more focused on cues from economic data and the policy outlook. Here too, there is some reason for caution. Following the 2016 presidential election, investors gradually marked up their expectations for US growth in anticipation of pro-business regulatory policy and tax cuts. Easy financial conditions and a pickup in growth elsewhere also contributed to positive growth sentiment. At this point, the good news is, in our opinion, already fully baked into asset prices. Expectations have coalesced around three percent growth in the US this year and next, and while first quarter data has been somewhat weak, these medium-term expectations remain firmly entrenched. With forward-looking survey data on activity and sentiment already near cycle highs, the scope for further upside surprises appears extremely limited. It certainly does not help to calm investors that in the US, the Federal Reserve will be increasingly challenged to extend the expansion while also limiting the risks of a sizeable uptick in inflation and a buildup of financial market excesses. We are already seeing some indications of how a Powell-led FOMC will balance these challenges, namely, by allowing the rate of inflation to run a bit above two percent over the next couple of years, with the expectation that gradual tightening will eventually cool off the labor market and prevent a sustained inflation overshoot. Unfortunately, the FOMC's track record on this front is not encouraging, as the chart below illustrates. There may be limited immediate risks of a recession in the US but it is not surprising that investors are increasingly discussing that possibility, given that the FOMC is now targeting a restrictive policy stance in the years ahead, and elevated corporate and household leverage suggest growing balance sheet vulnerability to rising rates or any exogenous shocks.

Figure 2. Unemployment Rate less CBO's NAIRU Estimate



Source: BLS, CBO, Board of Governors of the Federal Reserve System, NBER. Shading represents NBER Recessions

With the Federal Reserve now showing greater resolve to tighten policy, asset valuations may be vulnerable and risk premia should rebuild. Term premia in Treasuries could also increase, as it is unlikely that the risk-free curve has fully discounted the significant increase in issuance that will be required to fund tax cuts, the 2-year spending deal, and the Federal Reserve's balance sheet run-off. The most recent CBO budget outlook indicates that annual budget deficits will exceed $1 trillion by 2020, two years earlier than previously estimated. This is a prescient reminder that even after accounting for increased revenue associated with stronger growth, simultaneous tax cuts and fiscal stimulus do not pay for themselves. Still, the coming deluge of increased Treasury supply need not lead to a steeper yield curve, since Treasury is likely to focus its funding needs at the front and in the belly of the curve in an effort to control borrowing costs. But over time, increased Treasury supply combined with a withdrawal from asset purchases by the ECB and Bank of Japan all suggest scope for higher term premia in longer-dated sovereign securities in the G7 space.

The situation is somewhat different in the Eurozone. The near-term outlook for monetary policy is clear. The ECB has flagged its intention to wind down the Quantitative Easing (QE) program by the end of this year and then raise the deposit rate by the middle of next year. Indeed, we think it would take a lot of news to shift the ECB off that path. Further out, however, the uncertainty increases discontinuously. President Draghi's term expires in October 2019 and his departure could lead to a shift in the reaction function of the central bank with greater tolerance for inflation below, but not necessarily close to, 2% and greater anxiety about the use of unconventional tools. The pace of exit could quicken after this point, as could the approach to exit, with potentially greater emphasis on balance sheet run-off. On the data front, the activity surveys have shown a clearer stepdown in momentum, albeit from more elevated levels. We think it is more accurate to say that the risks of an acceleration in activity have diminished than it is to say that the central case outlook for growth has been revised lower. To add further uncertainty into the mix, the latest inflation data also raises questions about the momentum of underlying inflation, with some tentative evidence that the stronger Euro is finally starting to drag on core goods prices. The news on the political situation is mixed. On the one hand, the emergence of the Grand Coalition in Germany sig-

nificantly increases the likelihood of further progress towards European integration, and Spain appears to have shrugged off concerns around the political crisis in Catalonia. On the other hand, the outcome of the Italian election, and in particular the success of both Five Star and Lega, only raises our pre-existing concerns about fundamentals there. We see less hope for a unified economic policy agenda that addresses the state of the public finances, particularly with the end of QE looming on the horizon.

Developments in China also suggest reasons to temper any expectations for further upside global growth surprises. An acceleration in debt reduction and structural reform efforts is now underway, supporting our base case scenario of slower growth this year. We would point out, however, that the quality of Chinese growth continues to improve. Still, as China has been one of the primary drivers of global growth in recent years, this slowdown could have meaningful implications for growth elsewhere, especially for export-driven economies. It is too soon to reach firm conclusions, but it is possible that the recent step-down in global activity survey readings reflects a slowing in Chinese activity. This will bear close monitoring in the months ahead.

Positioning Assumptions and Implications

What is perhaps most surprising about increased market volatility is that some find it surprising at all. The global economy is, after all, in the later stages of the economic cycle, and it should be expected that investors will increasingly focus on downside risks to the outlook as a decade of central bank support begins to fade away.

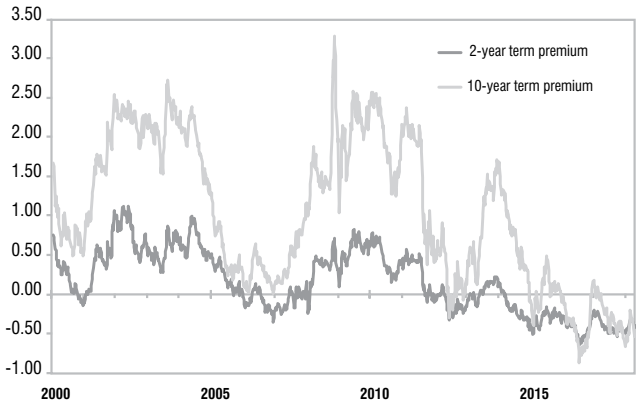
The halcyon days of 2017 which saw globally synchronised growth, reduced political uncertainty, and suppressed volatility have now passed. Global growth divergences are beginning to appear, and increased political uncertainty as well as the uncharted territory of central bank balance sheet normalisation now weighs heavy on global markets. The conclusion our team has reached as we enter the second quarter of 2018 is that risk premia will be reintroduced into credit spread-sensitive markets. In the immediate future the tailwinds of strong global growth will continue but further out into the second half of 2018 those positive tailwinds will slacken off. We forecast that US and EU earnings will meet and likely exceed expectations for now, but only for the next quarter. Due in part to base effects for revenue and earnings growth, we expect a slower pace of positive evolution later in the year. The positive tailwind of foreign buyers supporting US fixed income markets has all but erased as the relative attractiveness due to hedging costs now favours other markets. Over the coming weeks and months the team will be focusing on preparing the portfolio for the second half of the year by rotating into asset classes which are more defensive and less sensitive to rising yields.

In spread markets we are favouring higher quality sectors and names. With the meaningful repricing in front-end rates and credit, there are also potentially interesting opportunities in floating rate and other short-duration products, including investment-grade corporate securities, CLOs and ABS. Of course, the challenge is to ensure adequate market liquidity given our expectations for volatility to remain elevated compared to last year.

In sovereign rates, there are still select opportunities in European peripherals, though we remain attuned to political risks, particularly in Italy. US inflation break-evens also still provide value, as investors are still underpricing the inflation risk premium. As for the Treasury curve, the path of least resistance is for further flattening in the near term, but as the cycle continues to age we will consider the possibility of scaling into steepeners.

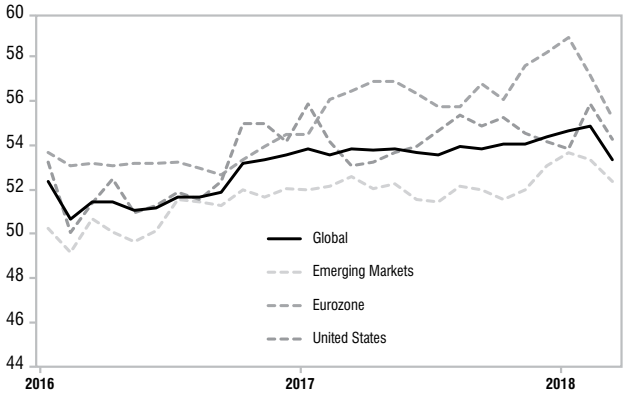
Regarding emerging mark debt, we entered 2018 with a strong conviction that local currency debt would continue to do very well, primarily driven by EM currency appreciation. Conversely, we believed that EM hard currency debt would not be in a position to deliver the stellar returns of 2017 as spreads were relatively tight and policy uncertainties originating in the US would continue to weigh on the asset class. Performance thus far has validated our views. Given the recent spread widening since February, we are seeing some short-term tactical opportunities in spreads again. This window of opportunity will not last for long, however. Longer term, local currency debt should continue to offer more value, though with some volatility. 2018 should remain a year of relatively high volatility with low correlation across sub-segments of EM fixed income (FX, rates, sovereigns and corporates). The era of the tide lifting all boats is way

Figure 3. Treasury Term Premia Estimates



Source: Federal Reserve Bank of New York

Figure 4. Emerging and Developed Market Composite PMI Indices



Source: Markit

behind us. Geopolitical uncertainties, including tensions between the US and Russia and the Syria crisis, as well as lingering concerns of an escalation in trade tensions, will continue to impact the asset class. However, we think these uncertainties are unlikely to derail the broader story: the overall macro background of solid growth combined with a gradual reduction of fiscal and balance of payments imbalances should continue to support EM currencies. Given that the EM outlook is increasingly desynchronised with some central banks still easing policy and others embarking on a tightening cycle, local currency will remain a land of idiosyncratic opportunities rather than a "buy the index" space. We keep a relatively negative bias towards low-yielding markets that should remain heavily correlated with US Treasuries, but continue to see many opportunities in countries with high real rates that are likely to ease monetary policy