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2019's diverging cycles offer opportunity

Many commentators have suggested that investing in bonds today carries a greater degree of risk than in previous years because the cycle is nearing its end. Unfortunately, this statement is not only unhelpful from an investment perspective, it is also inaccurate upon closer analysis of variations across industries, sectors, and regions. As we frame our outlook for the bond market in 2019, we think there are opportunities to generate attractive risk-adjusted income. These areas are best identified by understanding where markets are being led by diverging monetary policy and credit cycles.

Four distinct cycles

1. Monetary policy cycle:

Five years after it started a tightening cycle, the Federal Open Market Committee is now close to what it describes as a neutral rate. The Fed is likely to move from using "forward guidance" as an input to its policy path to "data dependence", where recent data trends will become increasingly important. In the absence of rising inflation, the Fed is likely to pause its quarterly rate hiking cycle in 2019 and take a wait-and-see approach. Meanwhile, other central banks are in different positions. In Europe, the European Central Bank is expected to begin raising interest rates next year, while in the UK the Bank of England may revisit its low interest rate policy should a reasonable Brexit outcome be reached. We see divergent monetary policy in emerging markets, with more central banks likely to join those that are already raising rates.

2. Sovereign credit cycle:

Growth has exceeded expectations in the US in 2018, but we have seen decelerating growth in other developed markets and emerging markets. In 2019 this is unlikely to be the case, as we expect this relationship to normalise, with stabilisation in Europe and emerging markets to rebound. The likes of Brazil, Mexico, Turkey, Argentina and even Italy have experienced disappointing growth and policy in recent years and many of these may prove to be good investments if policymakers can manage debt sustainably. But countries must show a commitment to credible institutions and prudent fiscal policy if they are to be rewarded.

3. Corporate credit cycle:

Aggregate levels of leverage in the corporate credit sector are higher today than five years ago. However, there is tremendous divergence by industry and region: while some corporates have increased leverage, others are reducing debt. We see a rebound in earnings for the energy, metals and mining industries, following three years of falling prices and rising defaults. Credit metrics in Europe look healthier than in the US, while debt loads in other areas, such as China, are more worrying. It is true that credit spreads look rich compared to the historical average, but this is why we are focusing on companies and industries committed to keeping balance sheets strong to withstand potential volatility ahead.

4. Consumer credit cycle:

The consumer, both in the US and globally, enters 2019 in its strongest position post-financial crisis. Income growth is finally starting to emerge, while household debt is still quite low. Pressures on traditional retail will continue based on shifting consumer preferences to shop online, but this is a secular shift in preference rather than a sign of weakness. Overall, we think it is a strong environment to invest in areas of the market tied to housing and consumer spending.

A more positive outlook

It is too simple to categorise the bond market in 2019 as “late cycle”. Monetary policy is diverging globally. US interest rates look more attractive as yields have risen meaningfully and the Fed’s reaction function is likely to change. Meanwhile, we remain defensive on interest rates in other developed markets as the rate-hiking cycle is just getting started. In corporate credit, we are concerned at the elevated level of leverage amongst US companies, but we find opportunities across the industry and regional divergences in corporate bonds. The consumer credit cycle is a bright spot, and we find attractive opportunities with the potential to generate income in the structured products market. Sovereign credit, specifically emerging markets, presents an interesting opportunity in 2019 following a sharp rise in yields, but will likely see tremendous divergence across countries. 2018 was a bad year for bonds, but 2019 has the potential to produce much more attractive outcomes for investors who can navigate very divergent monetary policy and credit cycles.

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