2019 Outlook_ Rates and inflation

Richard Edgar: 00:07

Hello, one of the most important issues for markets and the global economy in 2019 will be whether inflationary pressures start to take hold, and how central banks might react.

With me to take a closer look at this topic is **Anna Stupnytska**, Global Economist, and Portfolio Manager, **Peter Kahn**.

Well, thank you both for joining me today. Anna, let me start with you, what's your reading of the data at the moment and where do you think inflation might be heading in 2019?

Anna Stupnytska: 00:32

I expect to see slower global growth in 2019, accompanied by somewhat higher global inflation. This growth slowdown, relative to 2018, is going to be primarily driven by the US, with US growth converging with the rest of the world, as the impact of the fiscal stimulus falls out.

Also, China has slowed down quite sharply in 2018, and I expect this to continue throughout 2019. Some policy easing measures will perhaps kick in at some point to arrest that slowdown, but this is still going to be a key driving factor.

Richard Edgar: 01:14

Are there any lagging factors driving inflation. We've seen oil come down towards the end of 2018?

Anna Stupnytska: 01:21

Well, it will continue pushing up headline inflation due to the past effects of the oil price rally, but of course, the fact that oil is lower at the moment means it will cause a drag on headline and core inflation, which will remain throughout 2019.

We get the slowdown, particularly in developed markets, because of supply constraints, capacity constraints and because of tightening labour markets. That will continue to lead to inflationary pressures building up across developed markets, particularly wage pressures in the US and some parts of Europe.

However, I don't think it's going to be a story of really worrying inflation. Headline inflation might be a little bit above the target, core inflation is likely to remain relatively well- anchored around the target. So I don't think the central banks will have to become much more aggressive in tightening financial conditions.

Richard Edgar:	02:22	Do you agree, Peter?
Peter Khan:	02:26	Well, I think that's the base case for fixed income investors from a constructive perspective in 2019. The issue is that real rates have increased so much, in anticipation of this boom in inflation that should be coming through, that economies are growing more or less at capacity, or potentially above the potential output rate in the US, most specifically. We've seen that reflected in the rise in real rates and fixed income investors now actually have an opportunity to invest with some hope of positive real returns, given the corrections that we've seen in markets over the course of 2018.
Richard Edgar:	03:08	And how would you characterize the way that markets have behaved so far in this changing dynamic? Because people haven't run for the hills, what do you expect?
Peter Khan:	03:16	It has been very orderly, in high yield markets, up to date, despite many warnings and cautionary flags that have been flying in full for many years about the depth of liquidity in high yield markets. What we've seen generally is a risk transfer that has not produced anything uncontained, untoward or systemic in nature - but those issues have not been put to bed yet. That's the big question really for US credit markets over the course of 2019 is whether or not we're just going to go through the continual adjustment of getting ready for a lower growth period, or whether or not some of these exogenous factors from the global financial system might spill over into the US financial system. The odds at the moment seem rather low, but we don't know what 2019 will fully bring in the form of European systemic risk, in particular.
Richard Edgar:	04:19	And this is as corporate levels of debt continue to grow and yet you've got liquidity drying up as well - these are the two factors creating concern?
Peter Khan:	04:28	Absolutely. I mean, we shouldn't overlook the fact that we are in a fairly long-legged, aged expansion. What we're starting to observe in credit markets is the kind of behaviour that's really indicative of late-cycle risk appetite. This

is a watering down of investor protections, with an aggressive attitude towards the use of leverage from the issuer universe.

This is both in high yield leveraged loans, but also in investment grade credit, where we've seen an absolute boom in debt growth in the BBB sector over the course of the last five to seven years.

This has resulted from financial repression and low rates - if you were a corporate CFO or a treasurer, you would probably be a under a lot of pressure if you weren't taking advantage of these situations to continue to enhance your financial returns.

But these things always sow the seeds of their own destruction, if you will, and make that sector of the universe ever more sensitive and evermore dependent to what's happening in the overall macro growth picture. So the market as a whole has become a lot more vulnerable to a slowdown in growth.

Richard Edgar:	05:40	Is that something that the Fed would take into account, the enormous levels of leverage and then, if growth starts to slow as well, do you think they'll pull back from the hikes that have been signalled in 2019?
Anna Stupnytska:	05:58	I think, so far, they're very much focused on the domestic picture, they have been saying the economy is very strong.

Of course, it is mostly on the back of the fiscal stimulus and somewhat easy financial conditions that we saw in the previous years. Now financial conditions are tighter and that will be a drag on growth in 2019, as fiscal stimulus will be falling out as well over the next few months and quarters, and so growth is going to be slower.

But, what Peter was talking about, this story about the US corporate sector can be applied to all the markets in the global economy.

And, of course, emerging markets have also benefited from the extremely low cost of funding. They issued a lot of debt, also in the corporate sector, in the government sector and the consumer sector.

So these vulnerabilities that are out there and they have just started resurfacing. In 2018, we had Argentina and Turkey, some other small crises and blow-ups. Even though they seem like idiosyncratic events, they were the symptoms of the same issue and that's something that we will continue seeing over the next two years, and at some point the Fed will have to acknowledge it.

Richard Edgar:	07:16	So you said at some point they'll have to take notice. But what's the risk that they don't? What's the risk that they make a policy misstep?
Anna Stupnytska:	07:25	There is a risk because we don't know where the neutral rate is, no one knows. It is likely lower than in previous cycles and the risk is that if the US economy is doing 'okay' and inflation surprises on the upside causing them to tighten more aggressively, and then at the same time you have the China story and if the Chinese policymakers don't manage to arrest the slow down. Of course, this aggressive tightening in the US on the back of much higher inflation will be very damaging to the rest of the world.
Richard Edgar:	07:59	So Peter, Anna has mentioned several worries beyond the US. What else are you looking at?
Peter Khan:	08:05	Anna mentioned something that was rather interesting in terms of her outlook and the expectation of a convergence between policy rates and growth rates between other global blocs and the US. If we were to see that happen in a positive way, meaning that there are a number of political hurdles in the first half of 2019 for Europe in particular, most market participants want to take the base case view that not all of those obstacles are going to be navigated successfully. However, if they are, we might find ourselves looking at a European central bank that decides that the degree of extraordinary policy accommodation that they're providing is no longer warranted or, more importantly, the market shifting their expectations on what the ECB's reaction function will be there. That could really generate some significant and potentially disruptive moves in currencies, rates, and in the second or third order effect, the credit markets.

Richard Edgar: [09:13] Is there a lot of recalibration for markets to come to terms with?

Anna Stupnytska: [09:18] Yes, and actually a note on Europe, there is a lot of pessimism and for the right reasons, because there are a lot of risks like Italy and Brexit.

But at the same time, I think there's too much pessimism right now, because we saw some idiosyncratic factors in Q3 that contributed to a relatively sharp slowdown, particularly in Germany, in the industrial production sector due to the auto sector disruption.

So I think, as these temporary factors fall out, we might actually see some improvement in the growth trajectory.

Richard Edgar: [09:55] Well that's nice. You both managed to put a very positive side, or certainly an angle that we could look forward to in 2019.

Peter, let me just end by asking you, amidst all of these changes, where would you be looking for value in 2019?

Peter Khan: 10:10 The best opportunities at the moment are being created in those spaces that are getting starved of capital because of the flow of global capital back to the US, with its superior growth rates. That reversal will take some time and we'll need to be selective around that.

But the combination of emerging markets, in particular Asia, where we've seen a tremendous amount of liquidity-driven pressure upon the corporate sector, driving spreads on some very attractive assets from our bottom-up perspective to double the level where we started in 2018. As we finish the year and move into 2019 - those will be interesting areas for us to investigate for opportunities.

As will Europe, on a slightly slower moving cycle, given the fact that we don't have the significant events in Europe at the beginning of 2019, they may be more mid-year. So we'll be looking out for those two regions to create an opportunity for us to invest.

Richard Edgar: [11:18] So perhaps it's going to get worse before it gets better.

But there is light at the end of the tunnel, both with some individual opportunities, Peter, and Anna, the big picture from you as well.