



Taking on selective risks

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We expect the US economy to muddle through over the next 12 months, whilst avoiding an outright recession. Our investment teams are turning more selective and taking risks where they are well compensated. While the rising indebtedness in the US corporate debt market does not present elevated risks to the stability of the US financial system, we continue to monitor the situation.

The Eastspring Insights forum is a quarterly investment conference where Eastspring's chief investment officers and investment teams from across the 11 markets come together to debate and discuss key issues concerning markets. These regular engagements draw on the diversity and the on-the-ground expertise of our investment teams, helping us to navigate the changing market landscape and deliver long term performance for investors. Here are some of the highlights:

RECESSION NOT OUR BASE CASE

We expect the US economy to muddle through

over the next 12 months, whilst avoiding an outright recession. That said, much hinges on the outlook for the US consumer. The uncertainty resulting from the trade war has already weighed on business spending and manufacturing. US retail spending has remained resilient thus far, supported by still-healthy wage and jobs growth. In the latest NFIB Small Business survey (July), small business owners continue to exhibit optimism and have plans to hire more workers and invest.

Ironically, the resilience of the US economy and stock market may prevent President Trump from seeking a quick resolution, and we may need to see more "pain" before negotiations start in earnest. Meanwhile, China appears to be digging in for the long haul and is likely to provide greater policy support for its economy in the months ahead.

While the inverted US yield curve has caused some angst among investors, we note that credit spreads and the equity markets are not signalling an imminent recession. At the same time, with banks holding the highest amount of mortgages on their balance sheet since the Global Financial Crisis in 2008 (See Fig. 1), it is likely that the banks

purchased more bonds as yields fell in order to hedge their convexity. This may have exacerbated the decline in bond yields.

Meanwhile, most global central banks are likely to cut interest rates further or keep their monetary policies accommodative as global growth ratchets down. The US Federal Reserve for example cut rates by 25 basis points in September and committed to continue to act to sustain the US economic expansion. The IMF lowered its global growth forecasts in July by 0.1% for 2019 and 2010 to 3.2% and 3.5% respectively. However, with interest rates already low in many advanced economies, the effectiveness of more aggressive monetary easing is in question. Fiscal policy will need to step up, a factor which has yet to be discounted by the markets.

Fiscal easing has historically been limited by costs, the risk that government spending may crowd out the private sector as well as by countries' fiscal capacity. These should not be obstacles today given current low interest rates and low levels of private investment. Research also shows that the fall in yields since 2007 has increased fiscal space in all the G10 economies². See Fig 2. On the contrary, if interest rates had remained at 2017 levels, the US, Japan, Euro area and the UK would not have additional fiscal room.

According to the IMF, the positive impact of fiscal policy tends to be larger in downturns than in expansions and tend to be larger when monetary policy is accommodative or impaired. Hence, given current conditions, there is scope for fiscal policy to lend countercyclical support to the global economy.

WHERE COULD THE POTENTIAL RISKS LIE?

It is widely acknowledged that US corporate leverage has risen and corporate debt relative to the book value of assets is at a historical high. See Fig. 3. A highly leveraged business sector can amplify an economic downturn if companies lay off workers and cut back on investments.

In particular, leveraged loans have grown rapidly in recent years. In 2018 alone, leveraged loans outstanding rose 20%, reaching more than

Fig. 1. Duration delivery due to convexity flows for mortgage hedgers and insurance companies (USD billions of 10-year equivalents)¹

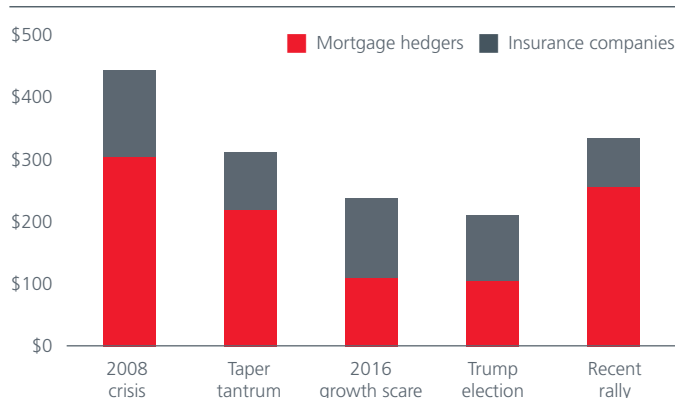
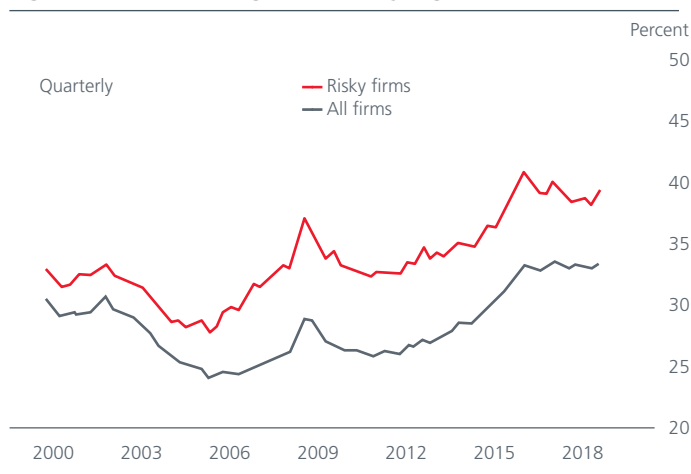


Fig. 2. Primary Balance Sustainability Gap* (%) - Positive gap represents fiscal space³

Developed Market	2007	2017	2017 (Using 2007 interest rates)
US	-0.01	0.20	-0.07
Japan	-0.20	0.30	-0.04
Euro area	0.10	0.30	-0.10
UK	0.01	0.30	-0.10
Australia	0.20	0.20	0.00
New Zealand	0.20	0.30	0.01

Fig. 3. Business leverage historically high in the US⁴





USD1 trillion. While we do not see any imminent risk at this stage, this is something to watch carefully as Collateralised loan obligations (CLOs) now account for about 62% of total outstanding leveraged loans and mutual funds are the next largest holders at 20%⁵. Meanwhile, underwriting standards have weakened somewhat.

While the rise in leveraged debt may have some parallels to the expansion in mortgage debt which resulted in the Global Financial Crisis, we note that US banks and other financial institutions are better capitalised today. The Fed's routine stress tests feature scenarios that include major stress in the corporate sector. The most recent stress tests indicate that even after the assumed losses, capital levels at the largest US banks are above levels before the crisis. We also note post the crisis, global regulators are actively monitoring developments in the corporate debt market and sharing information to strengthen the global financial system. In this case, knowing the size of the global leveraged loan market and the holders of the loans will help us better understand the underlying risks.

Separately, the profile of the Investment Grade bond indices in the developed markets has changed remarkably over the last 8 years with the proportion of BBB issues doubling from 20% to 45%. In a downturn, some of these borrowers could be downgraded into high yield territory, which may require some investors to sell their holdings. Likewise, over in Asia, while Korea (34%) dominated the JP Asia Credit Index in 2006, China now accounts for the lion's share (~50%). Traditional investors of investment grade bonds may not be prepared for the potential volatility that could emerge if growth deteriorates sharply. This would further strain market liquidity and prices.

INVESTING IN THE AGE OF ANXIETY

While the US equity market continues to be supported by the outperformance of the US economy and still healthy corporate margins, our investment teams are also finding opportunities within Asia.

Analysts have been revising down the earnings forecasts for Emerging Markets and Asia, narrowing the gap between expected and realised earnings. At a price to book valuation of 1.4x, the MSCI AC Asia ex Japan Index is trading close to its 10-year historical low. Within Asia, it is noteworthy that the China A market has been resilient despite the headline noise. With the weighting of the China A market poised to rise within the MSCI China and MSCI Emerging Market indices, the demand for China A shares from global asset managers will continue to increase over the coming years.

Within fixed income, most of our investment teams are moderately long duration and look to take risks where they are well-compensated. The teams are turning more selective within the high yield space, with an intense focus on credit quality as the fundamental backdrop deteriorates. Widely held Chinese property issuers sold off in August as global emerging market debt funds sought to raise cash levels. This potentially increases the risk for other "popular" issuers. On a positive note, there could be opportunities within Asian investment grade bonds given attractive valuations. Meanwhile, North Asian currencies are historically more sensitive to the RMB and North Asian exports are more vulnerable to the US-China trade war because of supply chain linkages. As such, the carry in the South East Asian currencies appears more promising.

Sources: ¹JP Morgan. ²Global Economics View – Automatic stabilisers may be needed, but are not strong enough. World Bank and Citi Research. ³Source: World Bank and Citi Research – Global Economics View – Automatic stabilisers may be needed but are not strong enough. August 2019. ⁴Debt stabilising primary balance less current primary balance. ⁵Federal Reserve Board staff calculations based on S&P Global, Compustat. Growth leverage is the ratio of total debt to the book value of total assets. Risky firms are firms with positive debt that are either rated as speculative grade by S&P or unrated. ⁶Business debt and our dynamic financial system. Jerome H. Powell. 20 May 2019.

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