Fed policy to cast a shadow over 2020

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Co-Head of Global Bonds Nick Maroutsos identifies the opportunities and risks he sees for fixed income investors in 2020 as the US Federal Reserve's near-term policy path remains far from certain.

Key Takeaways

- While we expect the current trend of global easing to continue, much of the fixed income investment environment may be dictated by the US Federal Reserve (Fed), which we believe hopes to delay rate cuts until a time that a slowing economy better merits them.
- With equities and corporate credits richly valued, this is not a time, in our view, to reach for yield or replace interest rate risk with credit risk.

Where do you see opportunities for 2020?

We expect the fixed income environment in 2020 to be similar to that experienced in 2019 in that the predominant trend will be one of growing policy accommodation by central banks, so there should continue to be opportunities within markets where yields and rates are heading lower.

We continue to like financials, particularly monopolistic-type entities in countries like Australia, Hong Kong and Singapore, where attractive yields exist, supported by well-capitalised companies. We also like issues from US banks, particularly the big deposit takers. We see merit in avoiding a home country bias, particularly in jurisdictions with negative rates, where we believe better opportunities can lie overseas where positive yields remain.

What do you see as the chief risk to markets in 2020?

We believe that inaction was the preferred playbook for the Fed during 2019, but the market forced its hand as concerns about weakening global growth festered. Fed policy is therefore a risk that merits close attention. We believe that lower nominal interest rates are a secular trend – and one from which the US is not exempt. Ultimately, we expect the Fed to re-engage in rate cuts, but their timing represents a risk to markets. Many investors have priced in a 'doom' scenario as represented by a flatter Treasuries yield curve. We do not foresee doom, nor do we think a near-term recession is on the cards. In the wake of the Fed's October statement, futures markets have backed off their expectations for 2020 rate cuts, but they still price in more than Fed officials estimate. Should the Fed stick to its guns and the yield curve steepen, we could foresee repricing across a range of risk assets.

We think it is also worth being vigilant about the state of the repo (repurchase agreement operations) market in the US. The frequency of the funding spikes is more telling than the magnitude. While it is still early days, it hints at wider stress in the system and we are not totally convinced that the Fed is tackling the source of the problem.

Are trade and politics a growing concern?

While inroads have been made in breaking the US-China trade impasse, a tenable resolution that could reignite the languishing manufacturing sector and soft trade flows is far from certain. Much of the optimism priced into riskier asset classes as we closed out 2019 reflected a ‘better-case’ trade scenario. The high valuations of both corporate credits and equities could quickly reverse should the two countries retreat to a more protectionist stance.

In Europe, the Brexit saga continues to hang over markets as do questions about whether the European Central Bank’s latest increase in asset purchases will move the needle for economic growth, especially if governments remain hesitant to implement fiscal stimulus. A new risk is the policy uncertainty thrust upon markets by the US election cycle. Sectors ranging from heath care and energy to technology and financials may all be impacted by the proposals of the leading presidential contenders.

Despite our view that a strong US consumer and accommodative policy by central banks will likely stave off global recession, the lack of clarity on this cocktail of risks means that investors should expect higher levels of bond market volatility. One place where this volatility may manifest itself is the longer end of the US Treasuries curve. Tight spreads may mean that the upside of US corporate credits is limited as well. Other markets appear better positioned as their monetary authorities are firmly in the easing camp and their corporate sector may not be as richly priced as comparable US issuers.

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