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It's time to mind your P's (politics) as much as your Q's (QE)

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Central banks have been the dominant influence in the market for many years now, taking us to levels of yields and valuations that would have seemed unimaginable when I started my career. They have driven the price of risk and the price of liquidity to ever more expensive levels. Arguably, even as I write this, they continue to have as much influence now as they have had over the last decade. The European Central Bank (ECB) has just embarked on another bond purchase program totaling Euro 2.6 trillion and the Fed's operations at the front end of the yield curve are just Quantitative Easing (QE) in another form. The official reasons, to us, sound technical and are about unlocking the blockages in the system, but the added bonus is that a steeper yield curve diminishes the risk of a self-fulfilling recession, triggered by the incessant talk of inverted yield curves!

However, with the stock of negative-yielding debt currently around 15 trillion dollars, we believe there is a strong argument to suggest that the influence of developed market central banks may have peaked. The baton is now being passed to politicians, who will be the key to breaking the cycle of lackluster global growth. In our view, the transition from central bankers to politicians driving the narrative inherently carries with it risks which may not be fully reflected in current market pricing.

Figure 1: Negative yielding debt rising substantially

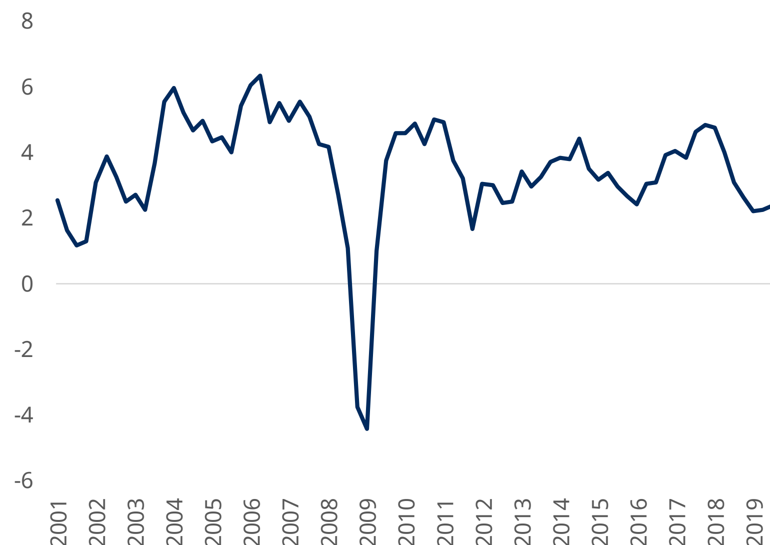
Source: Bloomberg, as of September 30, 2019.

The avalanche of "free money" has had multiple effects on financial markets and the owners of financial assets, while the impact on the actual economy is less clear. Yields have collapsed in fixed income markets, repricing risk and pushing many investors into previously unknown and riskier areas. For example, European high yield corporate issuers and Greece have issued bonds at negative yields. That

really is moving to the realms of the preposterous. It is questionable whether investor risk tolerance has changed or the search for yield knows no bounds and no risk limits.

An illustration of investors' heady return expectations is illustrated in the results from the Schroders Global Investor Survey 2019. Return expectations for the next five years in the Americas were 12.4%, Asia 11.5% and Europe 9%. Just digest that—European investors expect a 9% return in an environment when 30-year German government bunds yield not much more than zero and the investment-grade corporate bond index only yields a handful of basis points more than that! This dynamic is the driving force behind the mispricing of risk in financial markets. Economists and social scientists often talk of unintended consequences; it appears bolstering financial markets is the intended consequence, or at least the clear impact of QE, the surprise would be if it actually does anything to stimulate real economic growth. In summary, this has resulted in higher return expectations while actual economic growth has slowed (see Figure 2).

Figure 2: Global growth is slowing



Source: Bloomberg, as of September 30, 2019.

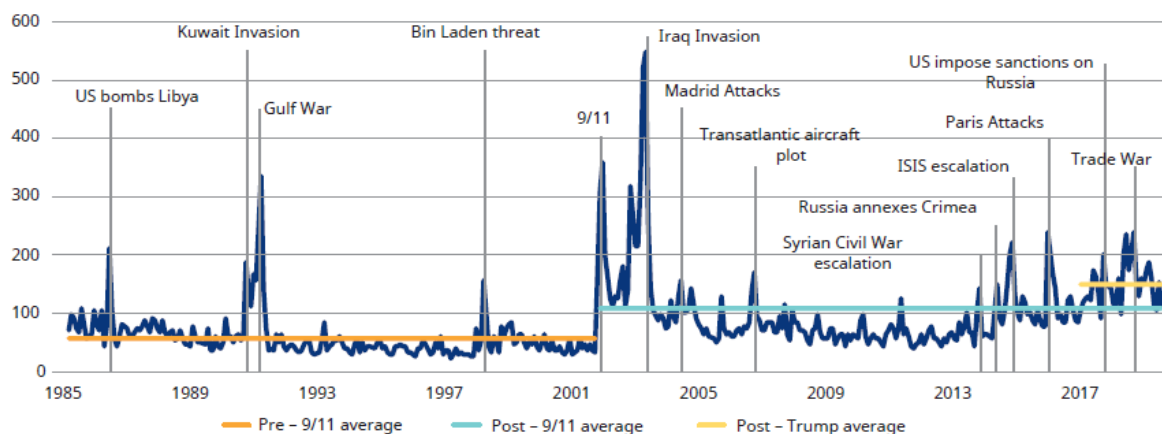
If QE is failing to deliver on its objective, and the impact on the areas that it continues to affect diminishes, something needs to take its place. It feels awkward to put this down in writing, and it's probably the first and last time you'll hear me use these words, but politicians might well be the answer. I am in good company here. Mario Draghi's final speech as president of the ECB echoed some of his previous comments about the limits of monetary policy and the need for governments to play their role with fiscal measures. In acknowledging that "low interest rates are not delivering to the same degree of stimulus as in the past", Mr. Draghi is handing the baton to politicians. It does appear that the appointment of Christine Lagarde, a lawyer rather than an economist, as the next president is a further indication of a pivot and clear sign that the next attempt at a solution will be a political one.

The influence of politicians is obviously significant but, I want to focus on two areas where they can have an instant and significant impact, one direct the other indirect:

1) Fiscal expansion
2) Geopolitics

A year ago, our economics team identified the disruptive and economic forces they thought would shape the decade ahead for investors—our 'inescapable truths.' Geopolitics was highlighted as one of the disruptive factors. As a phrase it is broad ranging but is often thought of as political/economic or military threats to the status quo. Figure 3, taken from that presentation, pinpoints the 14 primary geopolitical events going back to 1985. What stands out is that the first 12 episodes of heightened geopolitical risk were all terrorism or military in nature, but the nature of the most recent two were economic.

Figure 3: Geopolitical risk: Steep change after 9/11



Source: "Measuring Geopolitical Risk" by Dario Caldara and Matteo Iacoviello at https://www2.bc.edu/matteo-iacoviello/gpr.htm. Schroders calculations and annotations, April 11, 2019.

At the risk of oversimplifying complex issues around trade or political self-determination (Brexit, Catalonia), economically they could be seen as self-inflicted wounds. The atmosphere of uncertainty in Europe and the UK caused by the prolonged and yet unsolved issue of Brexit understandably reduces economic confidence and impacts future investment. Similarly, the volatile news flow in the US around the trade dispute with China and impeachment has a similar effect. These are not isolated events. Scottish independence will no doubt be back on the political agenda post-Brexit, and there are numerous other European countries with dramatically changing political landscapes—Spain is on its fourth election is as many years, and the UK its third since 2014. Issues like this are often triggered by the electorate and executed (or not) by the elected, but it is the uncertainty that impacts the confidence of businesses and consumers alike.

The US-China trade conflict is complex and includes elements of national security and intellectual property as well. It follows on from the re-negotiations of NAFTA to the USMCA and will no doubt be followed by a focus on the trade relationship between the US and Europe. As with the more political changes described in Europe, the detail of the negotiation is rarely the problem—outside specific industries. The real issue is the feeling of constant uncertainty; corporations want some short to medium-term stability to commit to any significant business investment, one of the drivers of future growth.

These issues are not specific to Europe or North America. The same pressures of populism and anti-globalization are felt around the world. However, with the ability of monetary policy in normal times limited to maintaining the current trajectory when geopolitical events strike, their effect now is even more in doubt. Politicians, at a minimum, need to work hard to provide a stable base from which economies can build.

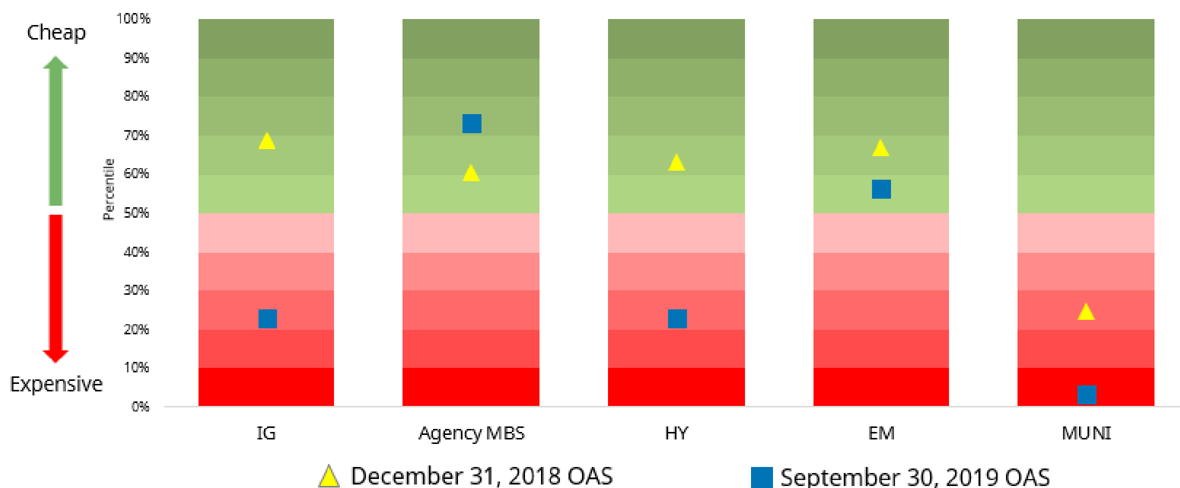
Stability is not enough. Politics also need to provide a catalyst for positive change, which is where fiscal policy comes in. President Trump moved early in his tenure to provide a boost to the economy, but thus far it seems to have provided a one-time boost rather than something more sustainable. Commentators will argue either that he should have kept his powder dry for a time when it was really needed or, alternatively, that it was the right idea, but insufficient against a backdrop of slow growth in Europe, China and the rest of the world. A second round of fiscal expansion may well be harder to deliver politically, at least before November 2020 and the focus on the deficit from some even within the Republican party may preclude it. However, both sides of the political aisle tend to agree on infrastructure, which may well be the most palatable way of pushing more government spending through.

So, how does this impact bond investors? The only way that current valuations in fixed income make sense, especially corporate credit given their poor fundamental backdrop, is because of the actions of central banks: low rates and QE. Whether these valuations can be sustained without politicians taking responsibility for their role in the economic environment is highly questionable. The hurdles for them to do anything and stay elected are significant. At the very least, they will take time to overcome.

Outlook

Having been happy to add back some credit risk earlier this year after the late 2018 sell-off, we have now gone full circle with value in credit and municipal sectors once again approaching the most expensive levels of the post crisis era. In an environment of slower growth, higher leverage and anemic earnings, we suggest approaching asset allocation with a degree of more caution.

Figure 4: Current percentile of OAS for various spread sectors over the past 10 years



Valuations suggest having a cautious stance on spread sectors

Source: Schroders and Bloomberg, as of September 30, 2019. Indices used are the Bloomberg Barclays U.S. Corporate Index, Bloomberg Barclays U.S. Mortgage Backed Securities Index, Bloomberg Barclays Corporate High Yield Index, Bloomberg Barclays Emerging Markets USD Aggregate, and ICE Bank of America 1-10 Year US Municipal Securities Index. Options-adjusted spreads (OAS) spreads fluctuate over time.

In contrast, we currently think certain sectors such as securitized and more specifically mortgage-backed securities, appear to offer more value. With spreads trading at the cheaper end of longer term valuations and a buoyant consumer underpinning fundamentals, this is a sector to which we are happy to allocate capital.

The credit market continues to be stuck in a tug of war between expensive valuations and deteriorating fundamental versus seemingly relentless overseas demand. However, as we know demand is a fickle friend, and we are happy to use continued periods of strength to prepare for stormier weather ahead.

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