Credit thoughts

YCAP asset management

November 2016

Let the Trumpets sound

Expect the unexpected

We are just entering beloved Christmas season but the outcome of the US presidential elections continues to leave more than an unpleasant aftertaste. Donald Trump's election has been a new victory for the anti-establishment wave which shakes worldwide political regimes. Market reaction to the shock Trump victory has been muted in contrast with the Brexit vote and more or less concentrated around the Emerging Markets sector and related FX amid speculation about a new wave of economic protectionism which would hurt such regions most. With some distance on time it seems that financial markets have arranged with it for the moment.

One issue markets face is processing the implications of a new president who, notwithstanding several high profile pronouncements, has run an election campaign lacking policy detail. Trump will be officially inaugurated on January 20 and much might be expected from the first one hundred days in office. Given a Republican majority in the House of Representatives and Senate and the president-elect's pronouncements about proceeding swiftly with change, the next five months will be crucial in shaping the Trump agenda. The strength of bell-weather indicators like the S&P 500 and the US Treasury rates and the US-Dollar appreciation reflect speculation about a strengthening of the domestic economy via broad based cuts to income tax, the increase of defense and infrastructure spending and deregulation. Besides, Trump has been strongly critical of multinational trade agreement, such as the Transpacific Partnership (TPP) which the president-elect recently announced to drop quickly. And Trumps repudiation of multilateral institutions such as NATO and the UN, his ambiguous views regarding Russian policy in Syria, his criticism of the Obama-brokered Iran nuclear deal and his defense criticisms of key allies such as Japan and South Korea raises the prospect of upending the global political order. To summarize, Mr. Trump remains a "source of volatility", which is not a really surprising observation in itself. The current buildup of his team and any comments from his side nourishing old fears about a President Trump are expected to keep market sentiment vulnerable in times where we will need to build a better understanding of the economic and foreign policy implications of the Trump win.

Over the short term, in the days to Christmas, investors will not only have to work down their shopping list, but have to keep an eye on the event calendar with some decisions ahead:

- On November 30, the members of the Organization of Petroleum Exporting Countries (OPEC) will have their 171st ordinary meeting in Vienna. Preliminary talks ended Tuesday without finalizing how OPEC´s second- and third.-largest producers (Iraq and Iran) will participate in a deal to cap production first outlined in September, deferring the matter until the group´s ministerial meeting at the end of the month. Against this background oil is expected to remain volatile amid speculation that the OPEC may fail to implement any output cuts. Any failure will mean a big loss of credibility and should send back oil price interim towards USD 40/bbl.

- Four days later, on December 4, a constitutional referendum will be held in Italy. Voters will be asked whether they approve of amending the Italian Constitution to reform the appointment and powers of the Parliament of Italy, as well as the partition of powers of State, Regions, and administrative entities. The outcome of the vote is closely combined with the political fate of Prime Minister Mario Renzi, as he has linked a “No” with his resignation. Latest opinion polls show the 'No' camp well ahead. New elections in 2017 as a result will come along with an uncertain outcome, where the chances of the anti-establishment 5-Star Movement of winning power may rise.

- And finally the US Federal Reserve will have to decide at its next FOMC meeting, on 13-14 December in Washington, about the next interest hike. In her testimony on Capitol Hill on November 17 Fed chair Janet Yellen said Trump’s victory had caused no significant change in the outlook for US growth, labor markets and inflation, and signaled that the US central bank could move to hike benchmark rates at its meeting next month. The Fed has not raised its benchmark rate since last December, when it rose from near zero to the current level of 0.25-0.5%.

Portfolio management implications

Given the filled event calendar before year-end and Trump on top of this we expect volatility in credit markets to accompany us until mid of December, where market activity then naturally begins to fade. We deem the Italian Referendum to be the most crucial milestone for European credit over the short term. A negative outcome of the referendum will cause a lot of uncertainty, imposing pressure on Italy and here especially on the banking industry, where clarity is a necessary precondition for implementing the needed sector restructuring. Against this background we currently refrain from any investments in Italian banks amid price contagion risk even for the better positioned financial institutions. In context with the referendum story in particular (but not only) peripheral risk premium has already widened in the forefront, and we cannot exclude risk aversion for European corporate credit to intensify around the voting date. Nonetheless, given the general supportive European framework and an accommodative European Central Bank on the forefront we do not see a huge move in systemic risk. Instead, we deem this as an opportunity as this also offers an attractive entry point in good quality corporates. A strong fundamental selection with a dedicated view on the capability to sustainably generate free cash flows even under weaker growth scenarios and adverse sector conditions will be worthwhile. Against this background, to give a concrete example, any failure of the OPEC meeting end of November to agree on production caps does not automatically justify in our perception to demonize a whole sector. A broad-based business mix with a competitive/low cost base and a plausible master plan for strengthening the balance sheet (disposal of non-core assets, capital measures) are supportive factors to separate the wheat from the chaff.

In context with the Fed hike debate the market is currently anticipating a very high likelihood of a rate increase in December. This in combination with the far-reaching implications of the Trump victory, suggesting a rise in inflation over the longer term, has already led to a significant rise in risk-free rates, not limited to US Treasuries, weighing on fixed income performance. However, further market reaction along with an effective rate hike cannot be excluded. Against this background we keep our current limited investment fund exposure towards USD denominated bonds with a preference for shorter duration. On the other hand ECB´s monthly asset purchases of EUR 80 billion under the Corporate Sector Purchase Program (CSPP) are intended to run at least until the end of March 2017, building a performance floor even under adverse conditions. With the exception of the Euro Corporate Fund, by nature focusing on such CSPP eligible assets, we tend in our other fixed income funds for shorter duration assets – a strategy which has turned out to pay in times of increasing uncertainty.

To summarize, the ongoing solid performance of the YCAP Funds makes us feel vindicated in our strategy to focus on high quality assets. Even if several decisive questions remain unanswered so far (not confined to Mr. Trump alone) YCAP is very confident that our deep fundamental approach for qualitative asset selection will ensure a safe navigation through uncharted waters.

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