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http://blog.en.erste-am.com/2016/05/06/default-risk-preferred/

Default risk preferred

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Equities have recovered from their beginning-of-year slump, and bonds, especially corporate and emerging markets, have recorded impressive gains. The loosening of the monetary environment in China and the continuation of the loose monetary policy in the USA have reduced the risk aversion of investors. In terms of asset allocation, we generally prefer default risk. Equities remain underweighted.

China: there will be another time

China has loosened its monetary environment. This is mainly due to an increase in credit growth. The budget deficits have expanded as well. Both factors support investment and the property market. The significant increase in property prices is particularly remarkable. For this reason economic growth will improve slightly vis-à-vis the low Q1 value. The fear of a “hard landing” has calmed. – For now, that is to say; it may be rekindled at a later date, seeing that the growth of debt is excessive in relation to economic growth.

No Fed funds rate hike

In the USA the central bank (Fed) has signalled a continuation of its loose monetary policy. The central bank is now less worried about the global economy and the financial market, although both areas remain under close scrutiny. However, economic growth in the USA has fallen. The growth rate of private consumption is subdued, and company investments and net exports are shrinking. Also, industrial production has declined, and banks have tightened lending standards for the corporate sector the third quarter in a row. The medium-term recession risks remain elevated. At least the leading indicators suggest a slightly higher rate of economic growth for the ongoing quarter, and employment growth is comparably high.

US dollar depreciating

The signal sent by the Fed of not raising the Fed funds rate in the foreseeable future has caused the US dollar to depreciate vis-à-vis a currency basket, and especially relative to the currencies of emerging and commodity-producing countries. This allows the central banks in the emerging economies to cut key-lending rates, or alleviates the pressure to raise rates. Here, the focus is on China as well: the depreciation of the US dollar against a currency basket has also facilitated the weakening of

the renminbi relative to a currency basket, although the renminbi has actually appreciated slightly to the US dollar. Also, the Chinese foreign currency reserves have stabilised after the earlier, hefty decline. Earlier worries over a chaotic and significant depreciation of the renminbi have dissipated.

The sectors with sharp previous corrections (emerging markets bonds, corporate bonds with low credit quality, commodities, emerging markets currencies, value shares) have recorded significant gains. The risk of interest rate hikes in the USA will be growing particularly if the still subdued growth rate of wages rises. By way of a converse argument, we can therefore expect the US dollar to remain weak and thus support the markets as long as inflation pressure remains low.

Good growth rate in the Eurozone

In the Eurozone the positive effects of the expansive monetary policy have become noticeable. The Eurozone GDP is growing at about 2% above its potential of 1%, the unemployment rate is falling, and credit growth is marginally on the positive side. However, as long as the excessively low rate of inflation doe not show signs of growth towards the inflation target, the ECB will maintain its very expansive monetary stance.

Negative interest rate policy and bond purchases

Given that negative key-lending rates also cause collateral damage, i.e. they are disadvantageous to financial institutions and to the customers of institutional investors, additional monetary loosening will probably rather happen via the extensive bond purchase programme (quantitative easing) and the long-term provision of liquidity to banks at favourable terms (TLTRO). This can help loosening the lending standards of banks (credit easing channel) and of the entire financial environment (portfolio balance effect).

No self-supporting improvement of the environment

Important leading indicators such as the purchasing managers indices do not suggest the self-supporting improvement of the global economy. Foreign trade in goods, industrial production, and company investments remain particularly weak. Also, the valuations across asset classes are generally elevated, company earnings are falling, the availability of additional economic and monetary signals has decreased, and the volume of debt in the private sector of emerging economies has increased.

Environment remains fragile

Two conclusions can be drawn:

1. The susceptibility of the financial market to bad news remains elevated
2. Additional monetary and economic stimulus measures are the driving factors for the positive development on the markets. The effect of such measures does, however, decline over time. In the short run, the wait-and-see stance of the Fed, which facilitates a depreciating US dollar, and the increased credit growth in China support the prices of risky assets.

Default risk preferred

In terms of asset allocation, we generally prefer default risk, i.e. primarily corporate bonds with low credit quality (high-yield), CEE government bonds, and emerging markets government bonds (hedged in USD). Equities remain underweighted.

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